Report on the Tesco Reporting Scandal

Corporate Governance and Social Responsibility

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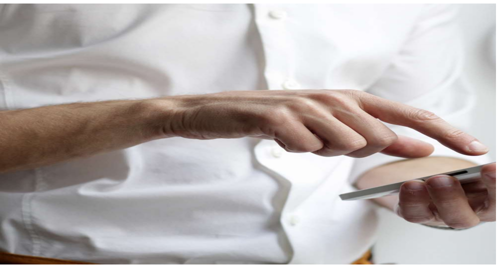
TREY research



Summary

The Tesco scandal talks about how it overstated its profits by £263m and misused the accounting standards and regulations. The scandal shows how multinational retailers shocked the whole world and market with their accounting failure. The report talks about how the company deliberately failed its governance and internal stakeholders and also shows the lack of supervision and corporate governance at Tesco.

There are three groups of reasons; inside weaknesses including viewpoints of short-Term objectives and weaknesses of directors, managers, and auditors; outside pressures which are comprised of competitors, suppliers, public, and market share; and finally cultural issues which are a general problem between almost all of the stakeholders working inside the company. As the last one is not referred to as a separate group of the internal employees, it is recognized apart from the others.

Despite the fact that the reasons to run a scandal are deliberate or unintentional decisions, the responsible individuals and officials could have prevented it with more sufficient courage, knowledge, and patience. Under the pressure of time and internal or external forces, their reactions to a small mistake, failure, or drawback were performed in a way to convert that small thing into a huge disaster, while the whole culture of the system was not enough to stop the whole wrong story.

How the Tesco governance system failed to detect the wrongdoings, has been responded according to its corporate governance framework as attached in appendix figure 4, ethical principles and Tesco governance code (governance principles and policies to be followed) and how they were unsuccessful in identifying, assessing, controlling and mitigating risks according to those structures, policies, and principles.

It has been observed that Tesco's overstatement of its profit to get the attention of the public and the investors to invest more has resulted in a decrease in their share price. Also, the level of trust in Tesco, in general, has been affected by this scandal (Table 1).

About Tesco

- “Tesco Plc (Tesco) is a multinational company for retailing of common merchandise as Tesco regulates business via ,many \ store presence and online also Tesco also manages stores in many ways such as the size and range of products sold, including small, large , one-stop shop and dotcom only (UKEssay, 2018).
- Tesco has a huge variety of food and other non-food products, which includes fresh food, liquids, fresh bakery products , groceries , at home and entertainment products, products for the babies like; games and toys , household appliances, gardening , clothing, pets, health , frozen food and beauty products and consumer electronics (UKEssay, 2018). Tesco has a service in insurance services and retail banking via Tesco Bank in the UK apart from this Tesco has their business established across EU, UK, USA. Tesco has their headquarters in Welwyn Garden City, the UK (UKEssay, 2018).
- “In Europe, Tesco has their market shares via management of acquisition as the purchase of the stores called as five Kipa in Turkey, in 2003 and the store called retailer Leader Price in Poland, for the year 2006” (UKEssay, 2018). “Tesco has made use of the similar strategy in countries like: Hungary and in the Czech Republic but they could not enter In the Asian market because of the local customer’s needs ,Tesco had to enter the market through joint ventures with local partners to access their business”(UKEssay, 2018).

When did the scandal start ?

2014 was the year of a financial doom for Tesco PLC. As a numerous faults were unfolding the accounting scandal, example; "Tesco issued their fifth profits warning in only 12 months, they reported a decline of 3,7% in like-for-like sales in Quarter 1 on 4th June which split their dividend on 29th August”(Financial times, 2014). “This situation was very devastating until an internal employee urged an investigation on Tesco’s accounting issues, which brought these practices in the eye sight of the management”(Barrett & Agnew & Fester, 2014).

On the 22nd September, Tesco surprised entire market around the globe with an agreement of them overstating their profit forecast for the half-year by £250m (Barrett & Agnew & Fester, 2014).

Tesco then made a release in press where Tesco agreed upon the overstatement was “principally due to the accelerated recognition of commercial income and delayed accrual of costs” & “On the basis of preliminary investigations into the UK food business, the Board believes that the guidance issued on 29 August 2014 for the Group profits for the six months to 23 August 2014 was overstated by an estimated £250m, some other of this impact includes in-year timing differences.” (Barrett & Agnew & Fester, 2014).

Misuse of the accounting methods

- “For the fiscal year (“2011/12”), “Tesco was recording the P&L in a unique way during which uploaded International Financial Accounting Standards (“IFRS”) in the given class period than requirements of reporting”(Persiani,2017).
- 1) “Recognizing fictitious commercial income”
- 2) “Delaying in the accrual of the costs”
- 3) “Overstating of the inventory”
- 4) Misrepresenting **“trading profit”** and **“underlying profit.”** “Specifically, Tesco violated IFRS the reporting requirements: IAS 18, IAS 2, IAS 37, IAS 34 IAS 38” (Persiani,2017).

WHY THE SCANDAL HAPPENED? WHAT ARE THE CAUSES? (Short-Term objectives) & Weaknesses of the directors/Managers/Auditors. 1,2.

❑ **Reason 1:**

- Short-Term rather than Long-Term Goals:
- Concentration mostly or even only on the short-term successes. Why; Usually because of what investors and owners want them and force the company to rocket the performance and attain the unreasonable highly preordered goals. (Miller, 2022)
- One example is the high-profit warning, 29 August 2014, which had to be achieved (Lovell, 2014)

❑ **Reason 2:**

- CG Weakness and Lack in Board:
- The lack of governing process to manage the risks. Therefore when a risk, like a decline in revenue, happens, the board of directors does not try to find a long-term, effective, lawful, and real solution. Instead, it searches to act in a short-term, risky, unlawful, ineffective, and unreal solution. (Wilson, 2020)

Reasons: Viewpoints (Short-Term objectives) & Weaknesses of the directors/Managers/Auditors. 3, 4.

❑ **Reason 3:**

- Ambiguous part of the story:
- Carl Rogberg, being acquitted after alleged, the former Tesco's director gave its place just some weeks before the discovery of the scandal to Dave Lewis, in September 2014.
- (Croft, 2019)
- This is just an assumption that something happened from the side of Carl Rogberg, the finance director, but had not been proven.

❑ **Reason 4:**

- The lack of CG inside the audit committee:
- In May 2014, the auditor (PwC) warned the company about the commercial income, but the audit committee did not pay attention to it. While Ken Hanna, who was the chairman of the committee, waved this warning aside.
- (Kukreja & Gupta, 2016)

Reasons: Outside Pressure; Competitors, Suppliers, Public, Market Share, 5, 6.

❑ **Reason 5:**

- Competitors' Pressure:
- The pressure from outside in the market due to the competitors, like Lidl and Aldi. These rivals became more popular, especially by use of the discount-chains business model (Lovell, 2014)
- Discounters in the recent decades by use of discount the chains-business model put a lot of pressure on some of the old and very famous retailers, their senior rivals, like Tesco. These giant old business systems do not have, sometimes, enough flexibility in the short-term to react fast and fruitful, so they either lose the market share or even collapse.

❑ **Reason 6:**

- Suppliers' Pressure:
- Tesco stated that because of trying to book income very fast, resulting from suppliers, the discrepancy happened. (Austin, 2018)
- This is an accounting process that seems to be an explanation away and not adequately acceptable.

Reasons: Outside Pressure; Competitors, Suppliers, Public, Market Share, 7.

❑ **Reason 7:**

- Profit Shortage:
- Falling the profits. Another force from leaders to the accountants to record the wrong statements of income. (Austin, 2018)
- As a piece of evidence, an example of losing money, we can look at the L'Oreal case, one of the largest companies in cosmetic industries worldwide, that Tesco demanded from it legally £1 million, and that company disputed. (Kukreja & Gupta, 2016)

- Mistakes, the Basic Problematic decisions resulted in Profit Shortage:
  - 2012 cost of £1.0 billion exiting to the US market
  - Opening some stores out of cities but being unable to adjust some changes properly in the habits of personnel, for instance, the increase in online shopping
  - Losing focus on the key business activities as a grocery retailing provider, going to the other sections of the market, like financing, restaurants, banking, cellular network services, and video streaming.
  - Refurbishment of the larger stores by adding some amenities like coffee shops and restaurants which had not resulted to have enough return.

(Kukreja & Gupta, 2016)

Reasons: Outside Pressure; Competitors, Suppliers, Public, Market Share, 8.

❑ **Reason 8:**

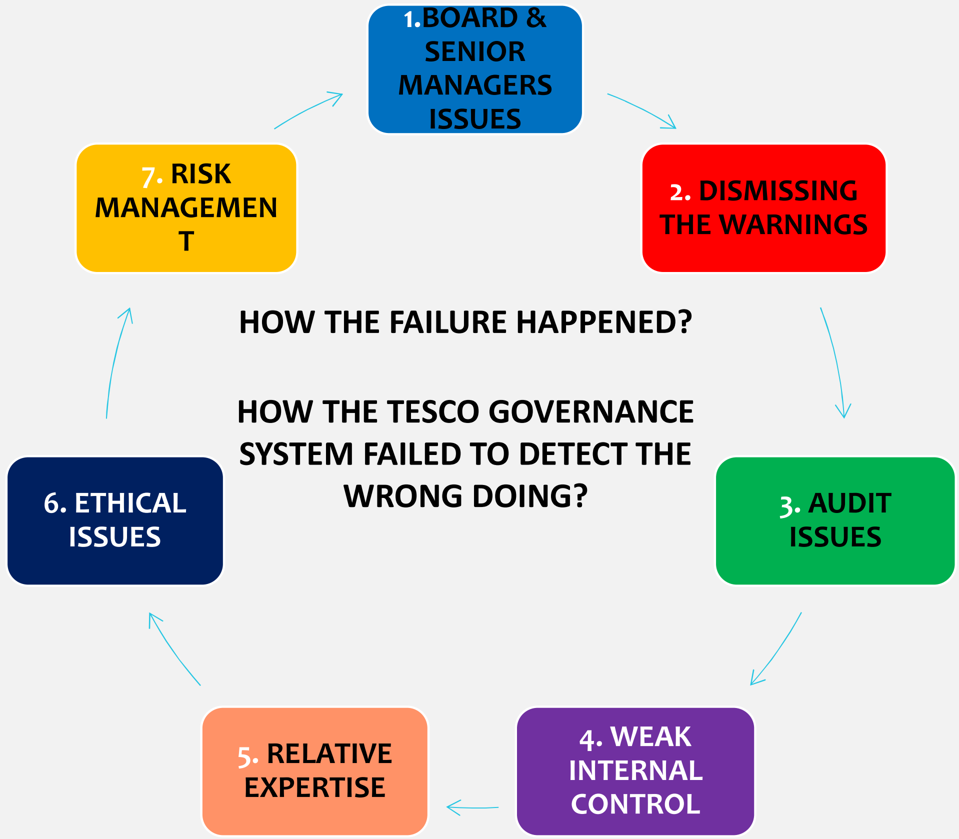
- For the 2013/14 fiscal year, the market share of the company rapidly reduced to just below 29 percent in the UK market. It was the lowest level in a decade. (Kukreja & Gupta, 2016)
- Usually, the market share is as strong as the price of the share in the market, and has a great power to put a lot of pressure on the executives to be extremely nervous and follow the unlawful solutions.
- Performance in a company is not a process of separately different sectors, but it is a continuous process between them. So when the market share is decreasing, particularly rapidly, then the revenue reduces at the same rate approximately. After that, the company is not able to pay its current debt (payable accounts). Following that other parts, one by one after each other like a chain of events, going to be weaker or even worse destroyed. Finally, this will go to the board and finance department to make a wrong illegal decision for the problem.

Reasons: Culture relevant cause, 9.

❑ **Reason 9:**

- The culture:
- Now after the whole story, the culture of transparency is renewed, mostly to affect the dialogue between the board of directors and the executives. (Wilson, 2020)
- Even though the whole employee is not directly and exactly responsible for issues of the financial statements of the company, they can feel to take care of what is going on in terms of safety and organizational health, to be benevolence for the company. It happens in some companies to provide the situation for their inside society in the way that they are a family and the firm is their home.
- **It is a kind of social loafing behavior, particularly, when personnel does not feel belonging to the system.**
- **Or perhaps, some fear of failure, such as losing their jobs, prevented them to react.**
- Reasons' Outcome:
- Viewpoints (Short-Term objectives) & Weaknesses of the directors/Managers/Auditors. 1, 2, 3, 4.
- Outside Pressure; Competitors, Suppliers, Public, Market Share, 5, 6, 7, 8.
- Culture relevant cause, 9.

THE FLOW OF FAILURE TO DETECT THE FRAUD



Board & Senior Managers issues

Changes, Dismissal and Resignation

❑ **Till 2010**

Sir Terry Leahy had been the CEO of Tesco" **<u>for 14 years"</u>**
Result: pre-tax profits raised from "£750 million to £3.4 bn"
(Fested, 2014)

❑ **2011**
Sir Terry Leahy resigned and was replaced by Philip Clarke
(Fested, 2014)

❑ **2014**

Resignation of the CFO (before scandal)
Resignation of experienced senior executives (before scandal)
Mr. Clarke was replaced by David Lewis

Nominations Committee

Wrong decisions & Mismanagement

❑ **Focusing on short term goals**

❑ **Inability to analyze the market & massive process failure**

- Entry into the USA **<u>in 2007</u>** and exited the U.S. market **<u>in 2012</u>**
- Declining in market share **<u>in 2013</u>**
- Diversified into many businesses
- Went wrong to adapt for changes in UK shopping style
- Renovate its larger stores and adding more facilities

❑ **Board Evaluation policy (internally & externally)**

Executive committee

(Fested, 2014) (Tesco annual report, 2015) (Fested, 2013) (Kukreja & Gupta, 2016)

Board & Senior Managers issues

For the purpose of setting up an outstanding “corporate governance”, the company board of directors have an important role in keeping effective “corporate governance”.

The **stepping down of Sir Terry Lealy in 2011**, after 14 years working as CEO, was a big and maybe shocking change in the board of directors, he was replaced by Philip Clarke that “lacked the strategic insight of Sir Terry”.(Fested, 2014)

The **resignation of the CFO** just before the scandal, quitted the company with no CFO. Moreover, it went along with the **resignation of some significant senior executives** which shows pure poor corporate governance and left Mr. Clark as the only executive director.(Fested, 2014)

The shaky changes in the level of CEO, Boards and the other professional executive managers during these 3 Years from 2011 to 2014, before and after scandal, made an insecure and unbalanced situation in the top levels of the company and the inability of the nominations committee in handling and selecting the board and managers, affect on the problems identifying and prompt decision making by the managers and lead to how the TESCO governance system failed to detect the wrong doings.

Board & Senior Managers issues

Tesco directors focused on short term goals, investors demand and on revenue generation. They ignored the damages might create for long-term goals of business, innovation, or customer relationships. Therefore, when they didn't put the value and concentration on long-term goals, they don't pay attention to how this manipulation will affect on them and can not detect it as a problem or warning.

In addition, Under Philip Clarke, Tesco diversified into many businesses and enlarged its services into areas. He started to refresh stores, concentrated on large "out of town outlets". The other decisions were: Exited the U.S. market in 2012, Decision that made Declining in market share in 2013, Went wrong to adapt for changes in UK shopping style (Fested, 2013; Kukreja & Gupta, 2016). The result of these decisions show that the Directors couldn't choose the right one for improving the financial status of the Tesco. It shows **the weaknesses of directors in recognizing and analyzing the main problem and giving solutions**, so in this situation because of the reasons, we mentioned, they failed to detect the reasons behind the failures for solving it, they went to the wrong way or they might detect the main problem but they selected the wrong solution to solve it or maybe they didn't consider it as a problem. Perhaps if the executive committee had played a more active role in advising the CEO and helping him make better decisions, they could detect the wrong doings.

Board evaluation policy: The Board had agreed a "three-year cycle" for board evaluation. They conducted an "externally-led" assessment in one year (2011/12) as the last one, followed by "internally-led" evaluations in the next two years (2012/13 and 2013/14), "one led by the Chairman and one led by the Senior Independent Director". (Tesco Annual Report, 2015), due to lots of changes in management roles, if they considered more external evaluation, they might be more successful in how the directors are in wrong way.

Warnings & Audit issues

Dismissing the Warnings

- Ignoring warning from "Tesco's CFO Laurie McIlwee in 2012"
- Dismissing the "warning about the risk of commercial revenues by PwC"

Audit Issues

- **Internal audit committee**

  Weakness of internal audit committee

- **External audit committee**

  30 years

  Should have been more robust

Audit committee

(Kamal, 2015) (Davey, Maidment & Holton, 2014)

TREY research

Warnings & Audit issues

- There were some “**warning signs”** that Tesco's top management ignored them, one of them was from **the former CFO** of Tesco, Laurie McIlwee, that sent “an internal email in 2012” and warned employees about shortcomings in the “company’s financial controls” (Kamal, 2015), also “during the 2013-14 year-end audit”, **PwC** brought into question “the income from commercial deals from suppliers” (Davey, Maidment & Holton, 2014). “They had raised this issue, third time”, but the directors and the “audit committee” did not consider them as an important problem (Kukreja & Gupta, 2016). Ignoring and didn't take both warnings seriously and inability of audit committee to report right information to managers, made them unable in detecting the misstatement and the wrong doings.
- **The Audit Committee** reports to the Board and during the year, “the Committee **receives regular reports from the external auditors”**. The Committee also **receives updates from Internal Audit** and talked to senior managers on their control responsibilities. Unfortunately, “Ken Hanna, the chairman of the audit committee, ignored the warning about the risk of commercial revenues being manipulated” (Davey, Maidment & Holton, 2014). In addition, “the external auditor PwC has audited Tesco since 1983”. “The **threat of familiarity** was high after a connection of 30-plus years” (Kukreja & Gupta, 2016). On the whole, Lack of proper cooperation and coordination between internal and external auditors, ignoring the principles of transparency (code of ethics) by audit committee, lack of controlling and hiring an external auditor for 30 years, stopped the company of recognizing and controlling the wrong doings.

Weak internal control

❑ Aggressive culture focusing on high return

❑ No job rotation within Finance department

Result: Decrease employee motivation

❑ Lack of segregation of duties. Holding role of Head of Audit and member of finance team

Result: Lack of skepticism

Hidden of the fraud

❑ CEO duality

Result: Conceal of fraud (Kukreja & Gupta, 2016)

Relative expertise

❑ Weak recruitment policy

❑ No requirements in supermarket experience (Luke, 2014)

NEDs Conflict of interest

Failure to comply with the UK Corporate Governance Code:

❑ Number of EDs exceeded NEDs

❑ Conflict of interest between 2 NEDS

❑ Resignation of 2 NEDs from the Board

(Luke, 2014)

Weak internal control

The evidence shows that Tesco had a weak Internal control in place. Following by an aggressive culture to boost the profit, it was the main driver to improve performance. So, that internal system was not properly monitored and tested.

- “Job rotation did not work effectively in the finance department. This resulted in decrease employee motivation. Only a few people were familiar with accounting and finance issues and the authority was concentrated in their hands. Therefore, outside staff from other department were difficult to understand what was go wrong”(Luke, 2014);
- “Lack of segregation of duties: the fraud was committed by member of finance team which was also head of the audit department. Thus, the fraud was hidden by him. Lack of control in accounting records was due to CFO resignation” (Luke, 2014);
- The excessive power held by CEO and Chairman. There no evidence available whether the role of CEO and Chairman was performed by one person. There should be clear responsibilities of roles between CEO and Chairman as stated in annual reports:

Chairman responsibilities in Tesco:

“Chairman runs the Board and responsible for promoting a culture of openness and effective communications between executive and non-executive directors and ensuring the Board develop an understanding of the view of the stakeholders. Chairman is also responsible for controlling whether an appropriate induction is provided to new Directors” (Tesco annual report, 2014)

CEO responsibilities in Tesco:

“CEO runs the company and responsible for strategic direction and implementing the agreed strategy Identifying and executing new business opportunities. His task is to ensure effective communication with shareholders and key stakeholders "(Tesco annual report, 2014)

Relative expertise

The evidence shows that there is a weak recruitment policy in Tesco because background in supermarket industry was not required and not considered.

- Group CEO is Dave Lewis was lack of experience in the supermarket sector. For example, he has an experience in marketing and customer relationship management. He worked in Unilever during 30 years (Luke, 2014);
- In addition, the non-executive board of directors had experience in different sectors like in government, telecommunications industry and in glass manufacturing. This means they dis not have practical experience in retail store (Luke, 2014).

NEDs CONFLICT OF INTEREST:

There was resignation of 2 board members (Kukreja & Gupta, 2016). Tesco failed to "comply with the UK Corporate Governance Code" which requires balance of Executive Directors (EDs) and Non-executive directors (NEDs) in order to avoid domination in decision - making. However, there was a conflict of interest between NEDs which resulted in failure to comply with Code and to detect fraud timely:

- Number of executive directors exceeded non-executive directors
- Conflict of interest between 2 non-executive directors
- Resignation of 2 non-executive directors from the Board

Ethical issues

Value is **"no-one tries harder for customers"** (Tesco annual report, 2014)

<u>Breach of law and regulations:</u>

As a listed company of London Stock Exchange, Tesco:

- ❑ Failed to comply with *UK Corporate Governance Code*
- ❑ Failed to meet its strategic value "*Set tone from the top*"
- ❑ Failed to comply with *UK Bribery act*
- ❑ Board of Directors failed to comply with their responsibility (Appendix 2): "*Financial Statement is prepared fairly and all significant information is sufficiently disclosed to ensure that the users are not misleading"*

Risk management

"In **September 2014** Financial Reporting Council made several amendments in the Code":

- ❑ Board and Chairman assessment evaluation
- ❑ External audit tendering every 10 yrs (Tesco annual report, 2014)

Key risks

Tesco failed to manage the following risks:

- ❑ Reputational risk
- ❑ Business strategy risk
- ❑ Fraud and compliance risks
- ❑ Financial risk

Ethical issues

As a listed company on London Stock Exchange, Tesco breached a number of law and regulations:

- Failed to comply with UK Corporate Governance Code
- Failed to comply with *UK Bribery act*
- Failed to meet its strategic value "Set tone from the top" (act ethically and professionally)
- Board of Directors failed to comply with their responsibility that *"Financial Statement is prepared fairly and all significant information is sufficiently disclosed to ensure that the users are not misleading"* (Appendix 2).

Directors have ethical obligation to act with honesty, integrity, loyalty, responsibility and fairness (Dunfee, Kline and Schwartz, 2005). The unethical behavior of Tesco resulted in attaining short-term gain and financial incentives. Negligence of the Board and Senior managers mean that they were not care about ethical behavior and run the company on the own interests which is against their fiduciary duty. Directors failed to "set tone at the top" meaning to act ethically and professionally. This is Board responsibility to ensure that ethics training is provided to the staff and company implements proper ethics programs. The directors failed to act in the best interest of shareholders due to false reporting and lack of transparency.

THE COMPLIANCE WITH THE FUNDAMENTAL PRINCIPLES WAS THREATENED BY:

- **Familiar threat:** Financial statements of Tesco were audited since 1983 by PwC (Kukreja & Gupta, 2016)**.** This resulted in applying a lack of skepticism during audit process, decrease in audit quality performance and loss of auditor's independence.
- **Intimidation threat:** The evidence shows that Amit Soni was a senior accountant and Soni said that under the pressure "he had induced his team to put together a detailed report on the scale of the profit hole at Tesco after he pressed commercial director for food John Scouler to ask for £200m in "relief" to be knocked off the second half target in 2014 but got only a "small number" (Butler, 2017). This proves that accounting fraud is collusion between several managers of Tesco.
- **Self-interest and self-review threats:** Head of Audit was also a member of finance/accounting team who performed accounting tasks which resulted in hidden of the fraud and reluctance to review own mistakes.

Ethical issues

- Tesco value is **“no-one tries harder for customers”** (Tesco annual report, 2014). This value means that Tesco was focusing on to be true with their customers because only this way, the company can be rewarded with customer loyalty.

- In 2014 Tesco’s Committee highlighted the significant issues including Finance Risk Register, fraud, bribery and corruption; compliance with the Grocery Supply Chain and whistleblowing issues (Tesco annual report, 2014)

THE UK CORPORATE GOVERNANCE CODE:

Due to manipulation of the data, in September 2014 the Financial Reporting Council made **several amendments to the Code of Ethics**. “*The 2012 version of the Code applies to the Company for the year ended 22 February 2014”.* These changes basically referred to directors’ and Chairman evaluation, and External audit tendering every ten years (Tesco annual report, 2014)

Tesco’s Board opinion was that the company complied in all material respects in accordance with applicable Code of Ethics for the whole of the year ended 22 February 2014. However, the provision E.2.3, stated that Ken Hanna was unable to attend the Annual General Meeting.

As per **new Code of Ethics**, provision C.3.7 requires to tender the external audit firm every ten years. In fact, Tesco did not changed its Audit firm within 10 years

Risk Management

One of the Board's fiduciary duty is to oversight risk management process as a part of day-to-day task (Appendix 2). Undetected accounting fraud which lasted from the year to year illustrated that Tesco had a weak risk management process. Board did not fully consider and control legal and ethical risks within organization.

Tesco failed to comply with the elements of the ERM process timely: risk identification, risk assessment, risk response, communication and monitoring. The evidence shows that Tesco's inadequate monitoring system, internal policies and procedures were not properly followed by employees; manipulation of the accounting data was hidden from year to year which indicate that risks were not properly and timely identified and monitored by internal and external auditors.

The Control Environment has not been fully effective in 2014 due to discover commercial income fraud. It was costly and time-consuming for Tesco to understand, evaluate and eliminate these control weaknesses.

CONTROL IMPROVEMENT ACTIONS WERE TAKEN INTO ACCOUNT:

- **Annual Risk Management Process.** Risk Registers are considered and updated on annually basis. Both Board and Executive Committee reviewed and refreshed its Group Key Risk Register as per changes in internal and external environment;
- **The Internal Audit Programmer.** Risk-based programmer of Internal Audit is conducted on annual basis and the status is monitored and reviewed by the Board;
- **Assessment of compliance activities and business unit level.** In 2014 Tesco reviewed its compliance reports including fraud and Code of Conduct investigations, Information Security reviews, ethical audits and grocery compliance reviews of stock (Tesco annual report, 2014).

Risk Management

Tesco failed to manage the following risks:

REPUTATIONAL RISK:

Commercial income fraud significantly affected on business reputation. Tesco failed to protect its brand reputation with compliance with ethical, legal and moral principles. This resulted in loss of confidence among key stakeholders, decline in market share. It has also adversely affected on recruiting talent management staff.

BUSINESS STRATEGY RISK:

The business risks affect the "going concern" status and create difficulties to compete in grocery industry. If company's marketing strategy is wrong, it affects on whole business. It assumes that Tesco experienced some restrictions to operate successfully in international markets.

FINANCIAL RISK:

Manipulation with accounting data resulted in financial risks because of failure to achieve budget plans and increase the level of gearing. The key financial risks relating to the Tesco Bank include interest rate, liquidity, credit and insurance risks.

FRAUD AND COMPLIANCE RISK:

Manipulation with commercial income is an evidence of fraud risk. While non-compliance with Code of ethics, law and regulations as in case of Tesco create both compliance and reputation risks (Tesco annual report, 2014)

The impacts of Tesco scandal , corporate governance & the loss of trust in Tesco generally

The Aftermath

- Tesco overstatement of its profits have had a significant impacts on it share price and value of stock.

Below points summarizes the aftermaths of this scandal:

- “Tesco share price slumped to an 11-year low today, down 11.5% to 203p. And wiped off £2.28billion off its market capitalization from £18.78billion to £16.5billion” (Wearden, 2014).
- “Market capitalization of Tesco had almost halved in the space of a year” (Kukreja & Gupta, 2016).
- According to Kukreja, G. and Gupta, S. (2016), the impact of Tesco stock falling in value is important to some people in UK, since pension funds and mutual funds invested in Tesco shares. Also, Tesco shares lost 40% of their value in 2014 (Wearden, 2014).
- Profits decrease about by 92% in the previous year. As a result, its share price reduced by more than 50% (Farrell, 2017).
- Tesco was alleged to pay £500 million fine and 125 investors also filed against this accounting fraud (Kukreja & Gupta, 2016).

The Aftermath (CONT.)

- Tesco stated that it will cut up to 10,000 jobs with 6,000 of from its head office (Kukreja & Gupta, 2016).
- DW News, 2017 reported that “A fortnight after being fined by the “Serious Fraud Office”, Tesco confirmed its annual loss of £40 billion pounds while their sales growth surpassed £1 billion pounds”
- Four executives were suspended (Awolowo, 2016).
- “The fall in profits had its impact on UK Treasury since Tesco was one of the major corporate taxpayers in UK” (Kukreja & Gupta, 2016). In the year 2018 share prices of Tesco reduced more than 9% due to the decrease in operating profit (Eley, 2018).
- Tesco’s profit were extremely affected as a result of the high debt and credit liability, Tesco shares fell by 6% in a day and a total of 16% dropped in the first half of 2020, this caused them to exit the international market and now operates in UK and Ireland. Where they could focus more attention on and regain their trust and suppliers back (Kukrej & Gupta, 2016).

The effect of the scandal on Tesco's corporate governance

Tesco scandal raised questions about Tesco corporate governance structure as it clearly shows failure in its corporate governance. Perhaps, the first step to the failure in their corporate governance was the lack of trust within company. Because the fact that **"a whistleblower"** considered it necessary to raise the issue through the General Counsel and not with the board clearly shows that, the probability of the board dismissing the issue at hand like how the audit committee ignored the findings of the PwC were very high.

- The board itself were ineffective with the task assign to them by the shareholders and as a result of that, the scandal cost Tesco financially as they were faced with substantial fines from the regulatory agencies
- Tesco is to pay £129m fine to the Serious Fraud Office (SFO) and also to pay £85m which was instructed by the Financial Conduct Authority (FCA) as a compensation for misleading around 10,000 investors over the value of its stock and shares (Flynn, 2017).

Also, not only did the scandal cost Tesco financially, but it also damaged the company reputation and the relationship it had with its stockholders and stakeholders as a result of lack of transparency within the company.

The effect of the scandal on Tesco's corporate governance (CONT.)

- **The scandal lead to the amendment of Tesco board**: In their 2015 annual report, the board announced to appoint new chairman, two new executive directors and three new non-executive directors who have the skills and experience to run the company. They also said that the number of directors may rise or fall in line with the regular procedure of the board development to make sure proper stability and succession potential in the Board’s Committee (Tesco annual report, 2015).
- **Changes to remuneration framework**: In Tesco 2015 annual report, the board decided to develop new strategy to improve their financial performance by building a more suitable, customer-focused Tesco. They went ahead to recommend changes to the executive remuneration for 2015/2016 to focus their performance measure on areas that are suitable for the shareholder value (Tesco annual report, 2015).

The loss of trust in Tesco generally

Tesco trust issues resulted in the reduction of the supermarket share price. The information provided by an internal whistleblower resulted in an 11% reduction on the supermarket giant's share price (Dilley & Herbert, 2014). "Trust is crucial in a board environment to promote transparency and accountability" (Leblanc, 2012).

- According to Quinn, 2014; A survey was conducted with 1,000 shoppers on Trust issues regarding Tesco in General. The results which is showed in table 1 under the appendix, clearly shows that more than 60% have less trust in Tesco as a direct result of the scandal (Quinn, 2014).
- According to Hobbs, 2016 "As much as customers may genuinely believe that Tesco has acted badly, the blunt truth is that most do not care enough to change their shopping habit" (Hobbs, 2016).

The survey which was conducted also checked the reaction of the shoppers. The results are showed in Table 2 under the appendix. According to the results, Its obvious that majority of the shoppers will not switch supermarket completely because of the scandal but rather, they will shop less at Tesco and also take into consideration the prices of the items before patronizing.

Lessons learnt

Lessons learnt

- **They dared to cover a problem, not solve it**

Because they (responsible people) are not always brave enough to accept the challenges or problems and instead of solving, change them to trouble.

This is more close to the fact that psychology matters. Psychologically all humans can be in the wrong way of doing either businesses or personal activities when they feel a high pressure on themselves and no eye to be kept on them, simultaneously.

- **Changes, Dismissal and Resignation in Directors**

Any changes in any level in an organization related to employees or managers, especially in key roles should be considered as an crucial issue and planned in advance. Organizations are more affected by changes within the ranks of top management and professional executives. In addition, if the company is doing well, any changes should be scrutinized, because it would be riskier and needs too much energy, resources and time for adaptation of new managers, employees and even the external parties, also the situation inside the system that must be passed on to the new managers should be clear and transparent. From the corporate governance perspective, the role of nomination committee is a weighty matter in any organization.

Sometimes, the changes are inevitable, such as retirement or resignation due to any reasons, therefore, companies should consider or train the appropriate alternatives for the important roles in advance.

Lessons learnt

- **Wrong decisions by Directors**

The wrong decision of Tesco's top management started from 2012, If Tesco had analyze the market precisely, maybe it didn't encounter with that much of difficulties. The **role of professional analysis** and hiring people from the lowest level to topmost level with enough and related expertise are important issues that should be considered in any organization. The lack of analysis and wrong information made Tesco to enter to new markets and businesses. On the one side Tesco has encountered with financial problems and a variety of markets and businesses, so the managers could not make the right decisions when they don't have enough control and concentration on information, markets, businesses and financial benefits. Maybe using "**Two-tier board structure"**, could decrease the number of wrong decisions, or **increasing the board meetings** could help and decrease the miscommunication between managers and committees (Cerulli, 2022). From the corporate governance perspective, we can not ignore the role of executive committee as an advisor to CEO.

- **Board evaluation**

In my opinion board evaluation is a very important matter that should be considered yearly and externally, especially in situations that a company has encountered lots of changes or is in unstable condition.

- **Dismissing the Warnings**

If the board had paid attention to messages from PwC and former CFO as an early signs they might have recognized the misstatement and minimized the consequences of wrong doings. Spotting the early warning signs of trouble and using suitable tools can help companies to decide promptly before everything become uncontrollable.

Lessons learnt

- **Auditing Issues**

The external and the internal audit committee of Tesco were equally responsible for such matters. The integration between them plays an important role in keeping the company in a safe condition. Additionally, The rotation of external auditors became mandatory by "**EU Audit Directive and the Audit Regulation"** in 2016 (Deloitte, 2015) and it can help companies to stop such problems in the way that increasing independence between auditors and clients.

- **Whistle-blowing policy**

The "whistle-blowing" policy needs to be implemented in any organization especially the large ones. We can not ignore the role of this policy in detecting the Tesco failure and the fact that a senior member of the accounting department brought up their concerns to the Legal Counsel. A appropriate "whistle-blowing" policy mean that the errors would have been specified sooner. (Tesco PLC, 2019)

- **Disclosure committee**

According to annual report 2013 and 2014 and the corporate governance framework of Tesco PLC, we can see a big change in committees. The disclosure committee has been added from 2014 to framework and one of its responsibilities is "how and when the Company should disclose the information in accordance with the Company's Disclosure Policy" (Tesco Annual Report, 2014). The creation of this committee can help the Tesco in such scandals and controlling the outcomes in future.

- **Relative expertise**

In the future the Company need to revise its recruitment process with focusing on hiring management with supermarket experience. It is important to keep in mind that "compliance with Code of Ethics" and "Corporate Governance" improves business performance, and first of all, this is indication how Board perform their role on behalf of shareholders.

Lessons learnt

Weak Internal control and risk management procedures:

- The evidence shows that staff were reluctant to follow internal procedures;
- The fiduciary duty of the Board was to correct the weakness in Tesco timely. Management was unable to see deficiencies due to its lack of the independence from the company. Actually, the Board was reluctant to any actions.

LESSONS LEARNT: The weak internal control is subject to the leakage of confidential information. Detailed audit plan procedures should be discussed with Audit Committee, especially focusing on key risk areas. Company should change its Audit firm each 8-10 years in order to avoid familiarity and self-interest threats. Rotation of the auditors is important as they will analyze information from "fresh pair of eyes" and give better recommendations on risk areas.

External audit does not provide 100% assurance because audit process is conducted based on a sample. Therefore, both Audit and Risk Committees should strength their internal procedures in terms of testing internal control systems. Company's Risk register should be reviewed and updated annually due to changes in external and internal environments.

Ethical issues:

It is important to learn that unethical behavior is not only damage business reputation but also results in legal and financial costs such as penalties, prison and endless lawsuits. Financial reporting of the company must be transparent in order to encourage investors to invest money into a stable business.

Lessons learnt

- **Trust Issues:** Trust is crucial in a board environment to promote transparency and accountability (Leblanc, 2012). Tesco clearly had issues with trust, and without trust, the flow of information becomes problematic.
- **Ineffectiveness of Directors:** The ineffectiveness or effectiveness of governance by the board of directors reflects in their performance negatively or positively. Tesco directors were resigning, along with some executives. It was known that they operated for six months without the chief financial officers who was supposed to have a direct responsibility in developing and implementing financial strategy for Tesco.
- Directors are accountable to shareholders which require adequate level of transparency and disclosures. Directors' reward and performance should be linked. It is important that directors do not create incentives for employees for unethical behavior. For example, intimidation threat may result that manager insist to manipulate with data. If this is a case, it means that fraud and corruption are a normal practice within organization and everyone will violate it.
- **Unexperienced Directors:** Non executive directors are to provide an independent oversight of companies and to challenge the directors actions. Tesco, prior to its appointment of the two non-executive directors on October 7, 2012 had no non-executive directors with the **"retail experience"**. This weakness suggest that the board was unlikely to have the necessary knowledge and the expertise to effectively question and challenge the company's directors (Williams, 2020).

Conclusion

To conclude, Tesco overstatement of its profit caused the company's decrease in share value and also its shareholders as a result of short-term goals to cover up their previous mistakes and to deal with the pressure from suppliers and competitors such as Lidl and Aldi. In dealing with these mistakes and pressure, Tesco management tackled it in an unprofessional and unethical way which indicates a weak corporate governance within the company. The poor corporate governance practiced by the board, especially with the audit committee, the absence of the chief financial officer and the lack of retail experience from the non-executive director contributed to this scandal. The fiduciary duty of the Board is to run the business on the best interest of shareholders and not damage the business reputation which leads to the loss of market share and trust in general. It is recommended that the company should have an effective corporate governance structure and implement it correctly to facilitate effective management and sound business decision making.

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Appendix

TREY
research

Appendix 1: Learning experience

- ❑ **How did you find the group work activity?**
- ❑ **Are there any issues from remote group work?**
- ❑ **How did you resolve the issues?**
- ❑ **What did you learn from the experience?**

Group working report

	Title	Description	Date	Location
1	First Deadline	Done	22 March	on Campuse
2	First Meeting	Done	28 March	on Campuse
3	Second Deadline	Done	31 March	on Campuse
4	Second Meeting	Done	5 April	on Campuse
5	third Meeting	Done	8 April	on Campuse
6	Final powerpoint	Done	13 April	online
7	Final Check and discuss	Done	14 & 15 April	online
8	between 25-35 slides	Done	-	-
9	a front slide with the title of your presentation (Report on the Tesco Reporting Scandal), the full names of everyone in your team and everyone's Cnumber and module name	Done	-	-
10	do not use dark background settings or fancy fonts	Done	-	-
11	full reference list should be provided in the Harvard format	Done	-	-
12	appendix	Done	-	-

Experience for Group Work

- **Srushti Mali:**

- As a group of 5, I loved working with my teammates. This was a new group for me. So working with everyone for the time was amazing as i got to learn a lot from everyone, especially Aida and Ruth who helped with writing the proper format of reference links and how they are supposed to be used. I learnt it's important to do your task on time or else others might suffer due to it. The topic and group activity has helped me understand corporate governance with a broad perspective.

- **Hossein Yazdi:**

- In terms of team-working, we, five totally different students with a sheer variety of attitudes, personality, and qualifications, utilized those differences in a significantly harmonious, pleasing, and contributory atmosphere to achieve the result with sufficiently high quality as well as intellectual agility. I enjoyed and achieved greatly practical experiences, such as time managing, task dividing, group thinking, brainstorming, and contribution to find and analysis data and information together. Aida arranged and set everything pragmatically as well as smoothly applicable.

- **Fatina Ashirova:**

- Our group team consists of 5 students. The diversity of our group team enable us to complete this assignment timely as per given deadlines. There were no any conflict of interest within the group. The completion of the group assignment was followed as per strict schedule meetings: 22 Mar'22, 28 Mar'22, 31 Mar'22, 05 Apr'22 and 08 Apr'22, 13-15 Apr'22. This assignment expanded our knowledge in both corporate governance and business ethics issues and enabled us to critically discuss and appraise unethical behavior in context of Tesco.

Experience for Group Work

- **Aida Zadgari:**

- I found the group work kind of real-life experience and also really helpful to my future career. We tried to learn a lot of professional skills such as time managing (making a timetable including the deadlines, meetings, tasks before the deadline), working with Google workplace, how to interact with each other, and everyone was really committed to the plan, but it was also difficult to correct people and managing the wrong works. In terms of remote group work, we worked with Google slides, google sheets, and google chat, and made a WhatsApp group. We help each other by sharing some useful sources and links. In fact, the team working is a very tough and challenging job for me. Always, The most difficult part is convincing your teammates and trying to achieve an agreement on a subject. I tried to practice this part more by listening actively and using the best way for giving explanations to my colleagues and I think, I have been successful in it.

- **Ruth Arthur:**

- The group work was very effective as every member of the group adhere to the task given to us individually and also attended the group meetings. Even with the individual task shared, we discussed and helped one another. Personally, I found this group assignment very interesting as it made me critically understand how poor corporate governance can cause a company downfall if care is not taken. I enjoyed researching more about Tesco scandal and overall, I enjoyed working with my Team Members.

Appendix 2: Board profile

Tesco is subject to Compliance with the UK Corporate Governance Code

<u>Board responsibilities in 2013:</u>

- ❑ The strategy and performance of key businesses
- ❑ The budget and long-term plans
- ❑ Corporate and social responsibility
- ❑ Shareholder feedback and reports from brokers and analysts
- ❑ Risk management and controls within the Group, including a detailed review of the Key Risk Register
- ❑ Reports from the Audit Committee, Corporate Responsibility Committee, Nominations Committee, and Remuneration Committee (Tesco annual report, 2013)

<u>Board responsibilities in 2014:</u>

- ❑ Strategy
- ❑ Budgets and long-term plans
- ❑ Corporate and social responsibility
- ❑ Shareholder feedback and reports from brokers and analysts
- ❑ Oversight of risk management process
- ❑ Reviewing reports from its Committees
- ❑ Financial statements and announcements
- ❑ Health and safety
- ❑ The commercial income investigation

<u>The Board had two main priorities in their response to the commercial income issue</u>:

- ❑ to ensure that nothing like this can happen again;
- ❑ changes in management, staff training and overall commercial relationship with our suppliers is being reset

(Tesco annual report, 2014)

Figure 1

The significant decline in price share before the scandal, until 2014, was one of the pressure from outside.

(InvestisDigital, 2022)

Figure 2

An extremely reduce in market share before the scandal, until 2014, was another outside pressure.

(Brinded, 2015)

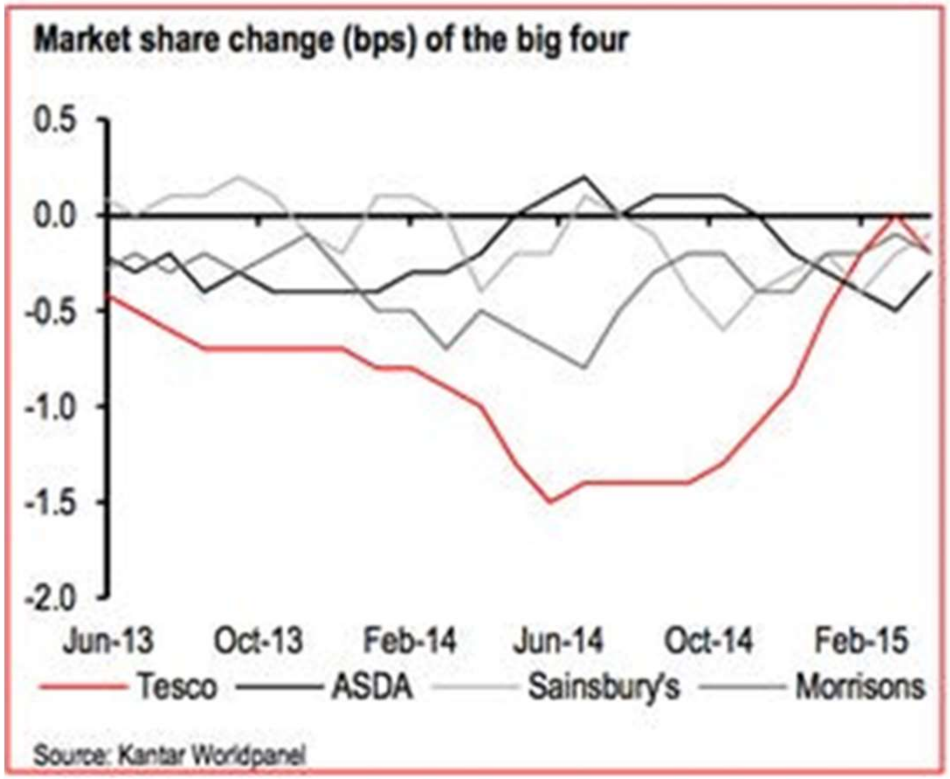
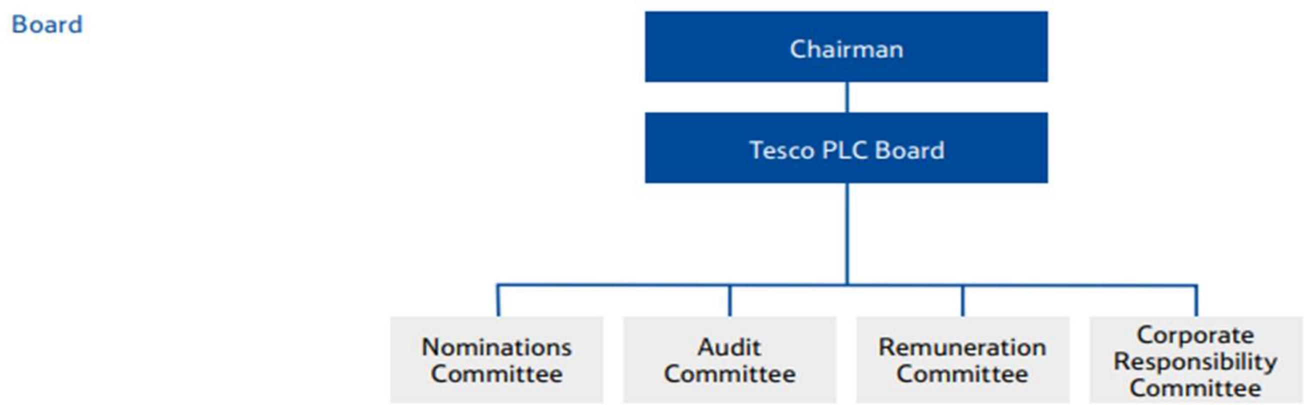


Figure 3

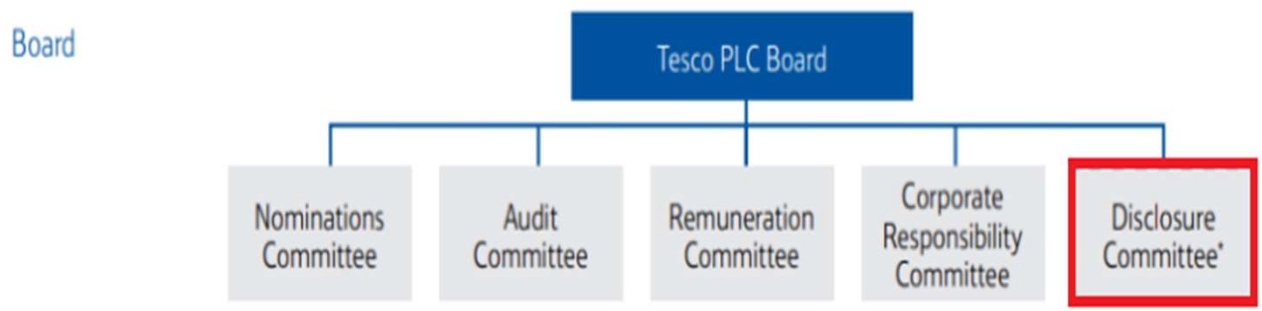
Compared to the industry, Tesco sales growth decreased before the time of event enormously. It was an huge dangerous alarm for the directors with a lot of mental pressure.

(Brinded, 2015)

Figure 4: Corporate Governance structure:



(Tesco Annual Report, 2013)



(Tesco Annual Report, 2014)

Table 1: THE LOSS OF TRUST IN TESCO GENERALLY

Survey conducted with 1000 shoppers concerning trust issues in Tesco in general. Quinn Ian 2014

Level of Trust in Tesco generally from shoppers	Sample Percentage
Much less trust	25%
Slightly less trust	36%
Same trust	37%
Slightly more trust	1%
Much more trust	1%

Table 2: THE LOSS OF TRUST IN TESCO GENERALLY

How shoppers reacted to the scandal

Shoppers Reactions	Sample percentage
Switched supermarket completely	1%
Shopped less at Tesco	13%
Started checking prices more carefully	13%

Thank You

TREY research