

# WINDOW DRESSING

The accounting scandal at Tesco made headlines, and Paul Merison explains why you must follow this story

**A**ccountancy students are forever being told that they should read the business pages, but often might not know how to spot relevant stories. On behalf of accounting students worldwide, I would like to thank Tesco for a beautifully timed disaster story.

For those who have been living on Jupiter in recent weeks, the basic story is that Tesco have overstated their profits by £263m. Just under half of this (£118m) is in the current accounting year, meaning first half profits were overstated (until Tesco corrected them). It has now emerged that £145m of the error is from prior years, meaning several years of accounts have been wrong.

So, what should students learn from the Tesco mess?

## Revenue recognition

The accounting issue is mostly about recording revenue too early. Deals done with suppliers that cause payments back to Tesco over a multi-year period seem to have resulted in too much of this revenue being front-loaded rather than spread over the life of the deal. I suppose one silver lining to the cloud is that this revenue is mostly not fake – it will find its way back into profits in the next year or two.

## Materiality

How did the auditors not spot such a huge mistake? Well, according to the last Tesco audit report materiality was £150m, and with no mistake in a single year of more than £118m maybe the auditors are not to blame for not detecting this. On the other hand, the reaction to this story (share price has fallen dramatically) suggests shareholders do find it material – suggesting that the materiality assessment should have been lower to reflect the high public profile of this leading UK company?

Talking of the auditors...

## Review reports

As audit students will know, only full year financial statements are subject to an audit. The half-year figures are subjected to a lower detail of testing called a 'review' assignment, on which 'negative assurance' is given.

In other words, less detailed testing means less likelihood that the auditors PwC would have spotted the errors.

## Auditor independence

PwC has audited Tesco since 1983. Familiarity threat springs to mind after 30-plus years, so one wonders if the



audit team might have lacked a little professional scepticism and failed to check the numbers as much as maybe they should have.

Audit committees are a useful aid to auditor independence – except that the Chairman of the Tesco audit committee used to work at... PwC! So much for the independence of the audit committee.

I imagine that the audit committee chairman might be changing rather soon – as, perhaps, will the auditors.

## Corporate governance

Well, where do I start? Some have already criticised the Tesco board for failing to have non-executives who have any relevant experience of the supermarket sector.

Then there is the company's failure to have a finance director for several weeks; when the previous CFO retired his successor was not ready to join – poor succession planning, surely.

Audit students will spot that having no CFO must surely weaken the internal control system over the financial statements, given the CFO is meant to lead this part of the business.

A couple of positives coming out of this story, in terms of good governance:

- The Chairman of the Board has announced he will resign, as he feels he should be held accountable for this mess (well done, because many in his position would stay put).
- Pay-outs to the recently departed CEO

and CFO, both of whom left before this story occurred, have been stopped until a fuller investigation has been completed, showing the new trend in clawing back payments to executives where there is the hint of poor performance. It is also worth noting that the chairman will delay his resignation a little, to allow the new CEO and CFO to get settled. Replacing the three most important directors on a board in one go is hardly the best strategy for any business.

## Foresnic investigation

For ACCA P7 students, what a nice example of a forensic investigation. Deloitte, assisted by lawyers Freshfields, have investigated the problems and issued their report. Several key Tesco executives were suspended from work while this happened – presumably because the forensic investigation went beyond looking at paperwork and required going through the email accounts of management.

## Conclusion

If you are studying accountancy, read every article on this story – and it's also worth reading the Tesco audit report (new format!) for February 2014 year end, where we can at least console ourselves that the auditors had spotted that revenue recognition was a key risk of material misstatement. **PQ**

• **Paul Merison, London director of ACCA, LSBF**