DOI : 10.15533/sdm/2016/v7i1/90217

Tesco Accounting Misstatements: Myopic Ideologies Overshadowing Larger Organisational Interests

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Abstract

This case study explores what went wrong in Tesco that resulted in the fraud of accounting misstatements of the magnitude of £263 million, why the fraud remained undetected over a number of years, which resulted in catastrophic consequences for both Tesco and its stakeholders. Furthermore, it highlights the lessons learnt from this debacle in Tesco, with focus on enterprise risk management, change management, corporate governance, materiality of transactions from accounting perspective, auditors' independence, sound accounting practices, internal controls and, employees' incentives policies. Finally, while the ultimate price of these scandals is paid by the society at large - particularly stockholders who put their hard earned savings in these institutions just on the basis of their trust on them – and while such scandals are often attributed to gaps in internal controls and auditors' negligence, this study concludes that, whatever controls are put in place or whatever accounting and reporting standards are set, if the people who are the part of system themselves decide to bypass the control systems, it is next to impossible to prevent such fraudulent activities. This case study has been prepared for educational purposes based on public available sources such as newspapers, magazines, websites and other referred articles.

Keywords: *Fraud, Accounting Misstatements, Internal Control, Corporate Governance*

1. Introduction

On September 22, 2014 Tesco, the super market giant in the United Kingdom, admitted that its profits for the six months ending on the 23rd of August 2014 were overstated by an estimated £250 million. Shares of Tesco tumbled to an 11 year low, wiping out almost £2 billion from Tesco's value. Four top executives were suspended including its UK managing director and an investigation covering the four past accounting years was initiated by Tesco (BBC News, 22 September 2014). All in all, once again another fraud involving misstatements in the financials of one of the largest and most reputed organizations in the world surfaced and once again investors' trust shattered, raising some serious questions on corporate governance, financial reporting practices, internal controls and auditing standards.

2. Key Events: Timeline

1919 Tesco was founded from a market stall in London's East End by Jack Cohen. Over the years Tesco's business grew manifold and it became the 3rd largest grocery and general merchandise retailer in the world. (BBC News, 9 September 2013)

2007 Tesco entered U.S. markets announcing ambitious plans for hundreds of Fresh & Easy stores

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(The Wall Street Journal, 6 December 2012). Sir Terry Leahy had been the CEO of Tesco for 14 years. Under his management pre-tax profits increased from £750 million in 1997 to £3.4 billion in April 2010. Tesco had become known as a highly customer focused retailer and was known as being the lowest price retailer in the "Big 4".

2011 On February 28, Sir Terry Leahy stepped down as Chief Executive and was replaced by Philip Clarke (Financial Times, 8 June 2010). Under Philip Clarke, Tesco purchased coffee shops, restaurants and digital businesses as it expanded its services into areas it thought might interest its customers. He started a program to refresh stores, which he claimed was bearing fruit, but this program focused on large "out of town" outlets when consumers were increasingly shopping at more convenient locations and shopping more frequently. He also cut the rewards for being a Club Card holder which was one of Tesco's key selling points.

2012 Tesco exited the U.S. market, which cost £1.0 billion (The Wall Street Journal, 6 December 2012). The company started to lose market share. Philip Clarke was criticized for allowing Tesco to lose its reputation as the cheapest of the "Big 4" UK supermarkets, a title that it lost to ASDA. "Hard discounters" such as Aldi and Lidl were increasing their market share drastically and more upmarket retailers such as Waitrose also were gaining market share. (BBC News, 19 January 2015)

2013 For the 2013/14 financial year, Tesco's market share sharply declined to 28.7% in the UK, the lowest level in a decade. (BBC News, 22 October 2014)

2014 In July, Tesco announced that Mr. Clarke would step down from the board on October 1 and would be replaced by Unilever executive, David Lewis who is already known to many people inside Tesco, having worked with the business over many years in his role at Unilever. Mr. Lewis was asked to start early in September because of what was happening in Tesco.

2014 On September 19, the General Counsel briefed the Chairman and CEO about the potential misstatement in profits.

3. How was the Fraud Detected?

On September 19, 2014, a whistle-blower, via the legal department, brought to the attention of the new chief executive, Dave Lewis, the fact that the company's first-half profit estimate, announced on Aug. 29, might have been overstated by £246 million. The whistle-blower, who was a member of the Finance Department, was concerned that his department was not receiving the full documentation related to commercial income. (BBC News, 22 October 2014)

The CEO and Chairman were briefed by Tesco's General Counsel on the situation. On September 22, 2014 Tesco announced the overstatement of profits. (BBC News, 22 September 2014)

As per the audited financial statements of Tesco for the year 2014-15, the total overstatement of profit before tax for the year ended 22 February 2015 was £53 million and a total overstatement for the years prior to that was £155 million. (Tesco Annual Report, 2015, p. 77, Independent Auditors' Report)

4. What Went Wrong?

Various types of sales incentives and vendor allowances are common in the Fast Moving Consumer Goods ("FMCG") and Retail sectors. These companies provide retailers and other customers with different forms of vendor allowances. Examples of such allowances can be:

- Cash in the form of volume discounts, and price protection.
- Cooperative advertising and promotional allowances.
- Slotting fees – these are the fees for displaying merchandise in more favourable locations, for example, at the plinth or an aisle or at eye catching areas.
- Listing fees – it is estimated that Tesco charges companies £80,000 simply to place a new product on their shelves.

- Buy one, get one free promotions.
- Return of expired goods and allowance for shrinkage.
- Late delivery penalties.

These deals are common practice in the supermarket industry and, although not disclosed, are estimated to account for one third of profits for the larger supermarkets. In the grocery industry, there is evidence that these payments are sometimes taken unilaterally. These payments may be disputed later, and a refund or a new agreement entered into, but by then, the original payment has been taken as revenue. Close to the end of a reporting period, buyers were regularly asked to "find" additional income, which; by implication meant finding such commercial income that could be brought forward. Tesco was too "ambitious" in forecasting these rebates in the first half of its 2014/2015 financial year and earlier years, and they may have manipulated the figures to enhance income and meet targets. Due to the size of these agreements, taking the income element early increased income substantially and made the meeting of targets significantly easier.

In a period where sales are rising and increased amounts of revenue are being realized, moving profits forward can be easily disguised, cloaked by increasing revenues in the second half of the year. Any issues in the first six months are "traded away". This means that the overstated profits could be hidden in the increased profit that generally occurred in the second half of the financial year. However, when sales are falling – as they had been for a number of quarters at Tesco – moving profits forward caused problems. Therefore, when the business was under strain, the manipulation was detected. (Business Insider, 2 October 2014)

5. Why the Fraud was Initially not Detected?

There were warning signs that commercial income was a problematic area. L'Oreal, one of the world's largest cosmetics company, was known to have threatened Tesco with legal action and withdrawal of its products from Tesco outlets due to a commercial income of £1 million which Tesco was demanding and L'Oreal had disputed. (BBC News, 19 January 2015)

The former Chief Financial Officer of Tesco, Laurie McIlwee, sent an internal email in 2012 warning employees about weaknesses in the company's financial controls after a problem was discovered in its Polish business. The email told finance staff: "You should be in no doubt as to the seriousness [of] miss-declarations" and said that accounting for profits early was forbidden "where [the profits] cannot be justified". (BBC News, 19 January 2015)

During the 2013/14 year-end audit, PwC had raised questions about "Commercial Income Accounting". They enquired how this income from commercial deals from suppliers was recognized (Business Insider, 2 October 2014). This enquiry was the third time that they had raised this issue with Tesco, but the company's audit committee had concluded that this area was not a problem. Senior staff at Tesco was highly incentivized to meet targets and this incentive structure may have motivated them to manipulate figures to meet targets.

6. The Aftermath

The overstatement of profit has had a substantial impact on Tesco, which was already suffering due to falling sales and profits. The following summarizes the aftermath of the discovery of the accounting error/fraud:

- Tesco's shares immediately declined and closed the day 6.5% down after the announcement (BBC News, 23 October 2014 & Business Insider, 23 October 2014).
- Shares in Tesco fell to their lowest level in 11 years on the initial announcement of the accounting error/misstatement. This meant that the market capitalization of Tesco had almost halved in the space of a year (The Telegraph, 24 October 2014). The impact of Tesco stock falling in value is significant to many people in the UK as Tesco was a share that many pension funds and mutual funds invested in.
- Profits for the six months ending on the 23rd August 2014, which were announced on the 23rd of October 2014, were down 91.9% to £112 million versus £1.3 billion a year earlier. (The Telegraph, 24 October 2014)

- The continued fall in profits at Tesco also had an impact on the UK Treasury as Tesco was one of the largest corporate taxpayers in the UK.
- Eight top executives were suspended (The Telegraph, 14 October 2014). Four executives remained suspended, one was reinstated and three left the company. At the time of writing, the entire top management team in Tesco has been replaced with a new team.
- An investigation covering the four past accounting years was initiated by Tesco, who appointed Deloitte and Freshfields Bruckhaus Deringer for this task (The New York Times, 14 October 2014).
- Tesco also notified the Financial Conduct Authority (FCA), which indicated that Tesco may have suspected foul play (BBC News, 22 September 2014). On the 23rd of October, 2014 the Deloitte/Freshfields investigation concluded that supplier payments had been "pulled forward or deferred" in a manner that was contrary to Tesco accounting policies. Further, the investigation found that there had been "similar practices in prior reporting periods" and that the sums "pulled forward grew period by period". The investigation found that the total overstatement was £263 million. Of that shortfall, £118 million related to the first half of 2014, with an additional £145 million relating to the past two years (Accountancyage.com, 23 October 2014). However, following further investigation these estimates have been revised. As per the revised estimates from Tesco's financial statements for the year 2014-15, a total overstatement to profit before tax of £53 million was for the year ending 22 February 2014 and a total overstatement of £155 million was for the years prior to that. (Tesco Annual Report, 2015, p. 77, Independent Auditors' Report)
- The Serious Fraud Office ("SFO") has commenced a criminal investigation and hence, the FCA has suspended their investigation. The SFO investigation could take several years. The SFO has the ability to prosecute individuals as well as companies (The Telegraph, 29 October 2014). Later on, the SFO announced that they also would investigate key suppliers of Tesco. (The Telegraph, 20 December 2014)
- Warren Buffet conceded that his investment in Tesco was a huge mistake and announced that he intended to sell his shares. Such a statement from an individual of Buffet's reputation might have had a huge impact on a company's reputation and value. Warren Buffet reported to his shareholders a loss of £287.6 million from the sale of his Tesco stock. (The Guardian, 1 March 2015)
- The Chairman of Tesco, Sir Richard Broadbent, stepped down on October 22, 2014 (Financial Times, 23 October 2014).
- On November 25, 2014 it was reported that a UK law firm, Stewarts Law, was soliciting Tesco shareholders to participate in a lawsuit against the retailer following the accounting scandal that had wiped billions of pounds off the company's stock market value. (The Guardian, 25 November 2014)
- On December 22, 2014, the Financial Reporting Council ("FRC") announced that it would investigate the "preparation, approval and audit" of Tesco's financial statements by PwC during the financial years ending in 2012, 2013 and 2014. The FRC also indicated that its investigation would cover "conduct in relation to matters reported in the company's interim results" for the first half of the current financial year. The FRC has the power to issue unlimited fines to individuals or firms to suspend them from professional accountancy bodies. As part of the investigation, the FRC will consider whether it should take regulatory action. (Financial Reporting Council, 22 December 2014)
- Both PwC and Tesco have announced that they will fully cooperate with the FRC's investigation. This investigation is expected to take around one year.
- On October 31, 2014, the rating agency Moody's warned Tesco that its debt could assume "junk" rating if it did not outline realistic plans to cut borrowing and improve trading results. (Reuters, 31 October 2014)
- Over the past few months, various reports have indicated that Tesco is likely to dispose off some of its non-core businesses including its mobile phone division and its data analysis operation. For example, Tesco has sold its video streaming service Blinkbox to Talk Talk. Now it is in talks with the bankers for selling its mobile business. (Retail Week, 11 May 2015 & Tesco Annual Report, 2015, p. 77, Independent Auditors' Report)

- Tesco has announced that it will cut up to 10,000 jobs with 6,000 of these from its Head Office. (The Telegraph, 14 February 2015)
- The final salary pension scheme of Tesco has also been closed which means that new staff will receive a significantly lower pension. (This is money, 8 May 2015)
- On February 4, 2015, the Grocery Code Adjudicator ("Adjudicator") announced that an investigation has been launched into the conduct of Tesco under the Groceries Supply Code of Practice. The Adjudicator is specifically investigating Tesco's conduct under provisions of the Code relating to delays in payments to suppliers and payments for shelf positioning. (Tesco Annual Report, 2015, p. 33, Corporate Governance Report)

7. Management and Governance Issues

In February 2011, after serving Tesco for 14 years, Sir Terry Leahy stepped down as the chief executive of the company and was replaced by Philip Clarke (Financial Times, 8 June 2010). Less than a year after his appointment, Tesco shocked the market with its first profit warning in almost 20 years. A change in top management at a time when the company was facing pressures on its revenue and profits was a red flag.

This also raises the issue of careful succession planning of change management in the businesses. Perhaps if Sir Terry Leahy had continued to participate in advisory capacity, whereby he could have shared his insights and experience to the benefit of Tesco for some more time while Philip Clarke was settling in his new role, might have led to a different story for Tesco.

In May 2014, when Tesco's auditor (PwC) had warned the company about the recognition of commercial income, the company's audit committee concluded it was not a problem. Ken Hanna, the chairman of the audit committee, dismissed the warning about the risk of commercial revenues being manipulated (Business Insider, 2 October 2014). If the board had taken PwC's queries as an early warning sign they could have minimized the misstatement.

The fact that the whistle-blower considered it necessary to raise this issue via the General Counsel is a concern in itself as this indicates a lack of trust within the company (Irish Times, 23 September 2014).

It has been a common factor in most financial reporting frauds - be it Satyam, Enron or WorldCom - that the beginnings are small and then gradually take gigantic proportions similar to a balloon being inflated and then bursting when it is unable to withstand the pressure. This is evident from various early warning signs that the Tesco's top management found it convenient to ignore; for example, an internal email of Tesco's CFO Laurie Mcllwee in 2012 warning the staff about the seriousness of miss-declarations as well as repeated mention by PwC to the audit committee about the risk in recognition of commercial income in the financial statements. These examples also throw into limelight another related issue that needs to be considered: whether it is the perpetrator of fraud that is more responsible or the one who is in a position to prevent the fraud and knowingly does not take any action until the situation gets out of hand.

While Tesco's business had grown exponentially, it is apparent that internal controls had not adequately grown. The buyer had substantial power to negotiate commercial deals with suppliers without any oversight from the Finance Department. The supplier arrangements clearly had sufficient "flexibility" to be open to some interpretation or renegotiation. Furthermore, the performance of senior staff members at Tesco were measured by meeting targets and highly incentivized to meet the same; this incentive structure also acted as motivation to manipulate figures.

Beside the above facts, there have been various business decisions that Tesco's management had been taking in the years preceding the detection of this financial reporting fraud which demonstrate the management's reluctance to adapt to the rapidly changing circumstances in the internal and external environment. Some such business decisions that proved to be grossly miscalculated are:

- Entry into the USA was not properly thought out. Tesco has been criticized for miscalculating the market and failing to cater to American tastes.
- Tesco continued to open large, out of town stores and failed to adjust for changes in UK shopping habits of shopping more frequently at convenient locations as well as increase in online shopping.
- Tesco diversified into many businesses, e.g. banking, mobile network, movie streaming and restaurants and consequently lost its focus on its core business, being grocery retailers. This also resulted in it losing its place as being the cheapest of the "Big 4" retailers.
- On trying to respond to loss of market share, Tesco started refurbishing its larger stores and adding more amenities such as coffee shops and restaurants. Arguably, this change did not result in an adequate return on investment.
- Tesco reduced the level of rewards provided as a part of its Club Card, which appeared to be a mistake, considering that its loyalty program was one of its biggest success stories.
- From a cultural perspective, Tesco became increasingly aggressive in trying to meet its earnings forecasts at a time when its profits were falling. This aggressiveness may have encouraged unethical behaviour by staffs who were trying to meet targets.

8. Lessons Learned

8.1 Enterprise Risk Assessment

Good audit committees (and the auditors) need to focus on key enterprise risks. Enterprise risks may not all impact the financial statements of the company, but as far as they do, these should be monitored by the audit committee and taken into account by the external auditors during audit planning. Furthermore, enterprise risks are dynamic. For example, five years ago, Tesco was not facing intense competition from "hard discounters". Therefore, such risks should be subject to regular review.

8.2 Change Management

Management change needs to be carefully planned and managed, particularly when such a change involves replacing key executives. Before the accounting scandal, significant change had occurred within the ranks of Tesco's top management. As part of any management change, an organization should do a "stock take" of where it stands and the situation that is being passed on to the new management. This approach makes it easier to ensure that new management does not inherit any surprises.

8.3 Materiality

According to the last Tesco audit report for 2014-15, materiality was £150m, with no individual error of more than £118 million. Also, as per the audited financial statements of Tesco for the year 2014-15, the overstatement of profits has not been considered material from the financial reporting perspective. (Tesco Annual Report, 2015, p. 77, Independent Auditors' Report)

Although the accounting error may not have been material from an accounting perspective, the error was certainly material to investors and other players in the financial markets, with Tesco losing billions in value with a resulting downgrade of Tesco's credit rating. Additionally, the negative publicity will take time to overcome. Materiality is normally a monetary value based upon a key item such as turnover, profit or assets. Perhaps, it is time that materiality also be defined in qualitative terms, taking into account investor and public confidence.

8.4 Auditor Independence

PwC has audited Tesco since 1983. The threat of familiarity was remarkably high after a relationship of 30-plus years. Arguably, this might compromise the auditors' independence in dealing with Tesco. The Competition and Market Authority ("CMA"), formerly the UK Competition Commission, has released its final order in relation to mandatory audit tendering and the responsibilities of the audit committee. The Order states that a 'Competitive Tender Process' must be performed after the stipulated number of years being audited. This must include bids from two or more auditors. However, it may be noted that the existing auditor can also participate in the tendering process and that there is no mandatory removal of auditor. In contrast, the EU rules require the mandatory rotation of auditors. Sarbanes-Oxley Act in the United States of America requires rotation of lead partner every five years. Some of the large companies including Unilever, HSBC, Shell, Diageo and Sainsurys had been replacing their external auditors' recently. This action of replacing ones auditors has been encouraged by the Tesco situation.

8.5 Corporate Governance

- Some reports also criticized the Tesco board for failing to have non-executives who have relevant experience with the supermarket sector. Furthermore, there was a severe failure in corporate governance by not having a Chief Financial Officer for five months (BBC News, 22 September 2014). Many people believe that the audit committee should have reacted promptly and decisively to the issues related to commercial income that PwC had raised. Perhaps, PwC should have been more robust in dealing with the audit committee regarding this issue.
- The effectiveness of Audit Committees needs to be improved through appointing members with accounting and auditing knowledge, industry knowledge and experience in the specific business. More regular and quality meetings need to be held and members of the Audit Committee need to be prepared to robustly challenge the auditors and management regarding internal controls (especially in high risk areas). Furthermore, the external auditors need to be robust when raising concerns with the Audit Committee. Best practice also suggests that Audit Committees need to be "educated" through briefing sessions from key personnel within the business.

8.6 Sound Accounting and Internal Controls

- In many companies, the value perceived by the investors is in the business model. Clearly, the business model, a company's position in the market, and profitability are often the main determinants of its share price. However, the Tesco case indicates the impact that not having sound accounting practices and strong internal controls can have on the value of a business.
- There are changes needed in the entire area of financial accounting and reporting such as fewer complexes, more intuitive and more understandable GAAP, and these should be clearly interpreted and consistently applied.
- Better and pragmatic auditing standards are needed, especially in the areas of revenue recognition, accounting estimates, allowances and reserve and loss accruals. Furthermore, organizations need to develop clear guidelines as to how these standards are applied and external auditors need to ensure that these are applied as part of the annual audit and interim reviews.
- Unduly complex transactions need to be avoided as far as possible. Where such transactions are inevitable, the company needs to strictly define and monitor the treatment of such transactions.
- A strict code of conduct and "whistle-blowing" process needs to be put in place in any large organization. The fact that a concerned senior member of the accounting department had to raise their concerns to the Legal Counsel rather than directly to the Audit Committee, the CFO or the CEO is concerning. A proper "whistle-blowing" process may have meant that the accounting error would have been detected sooner.

8.7 Employees' Incentives Policies

There are some causes that may encourage accounting irregularities to develop such as the value of performance-based compensation, especially the value of options, bonuses and other variable compensation awards, for the CEO and CFO and other senior management. These create a great temptation to manage earnings, set unrealistic revenue and profit targets and manipulate accounting to achieve results in line with market expectations. Incentives need to be aligned on the basis of a "balanced scorecard" with zero tolerance of aggressive accounting measures to achieve financial results.

9. Remedial Measures being taken by TESCO

Major structural changes have been initiated in Tesco, which include: overhaul of management structure and a new management team, reduction in capital spending, moving out from non-core businesses, greater focus on 'cost prices' than on 'commercial income', a new Code of Business Conduct supported by a company-wide training programme to help employees follow key policies with stronger focus on ethics and compliance. (Tesco Annual Report, 2015, p. 6 & 7, CEO's report)

Overall commercial relationships with the suppliers and the incentive structure of Tesco's commercial teams are being reset. Tesco's audited financial statements for the year 2014-15 carry enhanced and more transparent disclosures with regard to its accounting of commercial income. Greater emphasis is being given on proper accounting of commercial income. (Tesco Annual Report, 2015)

After 32 years Tesco's external audit has been put to tender and PwC has mutually agreed that they would not take part in the tender. Tesco has named Deloitte as its new auditors.

Tesco is investing significant time and resource to understand, evaluate and remediate the control weaknesses. Clear control improvement plans are in place. (Tesco Annual Report, 2015, p. 39, Internal Control)

10. Conclusion

Preventing financial statement misstatement fraud is like preventing sin. There always will be malefactors, but financial fraud can be minimized and its effects can be reduced if there are controls and checks and balances in place to detect and prevent it. It is self-evident that all financial frauds start small, and then grow bigger and bigger, until they cause significant harm to the investors and other stakeholders. Experiences, based upon investigation and analysis of many frauds, demonstrate that adequate internal controls are a better preventative measure than effective auditing.

To conclude, the natural cause of all the above types of scandals is attributed to the gaps in internal controls and auditors' negligence. In the aftermath of the scam, generally the CEO and the auditors bear the brunt of the attack from The Guardians of society, the press, the regulators as well as the public.

The ultimate price of these scandals is paid by the society at large, particularly stockholders, who put their hard earned savings in these institutions just on the basis of the trust on them. However, whatever controls are put in place or whatever accounting and reporting standards are set, if the people who are the part of system themselves decide to bypass the control systems, it is next to impossible to prevent the frauds like Tesco.

11. Limitations of the Study

All the information used is available in public domain and authors have no access to inside information. Furthermore, the opinions expressed are those of the authors and cannot be represented as the views of anyone else. Where the views of others are expressed, these are referenced appropriately.

Both authors have never worked as auditors or in other capacities with Tesco and they have never held investments in shares of Tesco. The authors have not interviewed any parties that have been involved in the management of Tesco, the audit of Tesco or the investigation of the fraud.

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