

## EOS Case Study

November 2020



# Tesco

Tesco has made substantial improvements to its processes for risk management and internal controls, as well as to employee incentives and supplier practices, following an accounting scandal in 2014. The link between strategy, conduct and culture, as well as human capital management and treatment of suppliers remain important topics for EOS' engagement with the company.

## Background

In September 2014, Tesco announced that it had uncovered an overstatement of expected profit in its results, principally due to the accelerated recognition of commercial income and delayed accrual of costs<sup>1</sup>. An independent investigation confirmed the overstatements, which impacted the accounts for 2014 and a number of previous years<sup>2</sup>. External investigations followed from the UK Financial Conduct Authority, the UK Serious Fraud Office and the UK Grocery Code Adjudicator (GCA). Incoming CEO, Dave Lewis, who joined just before the misstatements came to light, confirmed that poor supplier practices, driven by an absolute focus on the operating margin were contributing factors<sup>3</sup>.

For investors, the issue was a concerning reflection of the company's strategy and underlying culture, as well as its processes governing financial audit and risk. This followed the horsemeat scandal in 2013<sup>4</sup>, which had already damaged public trust in the company.

## Our engagement

EOS at Federated Hermes met with the senior independent director in October 2014 to discuss where accountability lay. Due to an ongoing investigation, we were unable to discuss the issue in detail but questioned why the audit committee had dismissed commercial income recognition as a key issue

<sup>1</sup> <https://www.tescopl.com/news/2014/trading-update-1/>

<sup>2</sup> <https://www.tescopl.com/news/2014/interim-results-201415/>

<sup>3</sup> <https://www.bbc.co.uk/news/business-35408064>

<sup>4</sup> <https://www.theguardian.com/uk-news/2013/oct/22/horsemeat-scandal-guardian-investigation-public-secrecy>

<sup>5</sup> See 2016 EOS Tesco case study for more details: <https://www.hermes-investment.com/ukw/eos-insight/eos/tesco-board-remuneration-supply-chain/>

## Engagement objective



### Governance:

The company improves its oversight of financial risk management, including developing centralised risk management systems for financial auditing.

## Company overview

Tesco is the UK's largest food retailer, offering online retailing and brick and mortar supermarkets, selling branded and own-brand products across grocery and general merchandise categories. It also operates a food wholesaling business, Booker. As well as the UK, its home market, Tesco operates in the Republic of Ireland, Czech Republic, Hungary, Slovakia and Poland. It is a significant employer, with more than 400,000 employees. In March 2020, it announced the sale of its Asia businesses.

for its consideration, a topic that the auditor had identified as a key risk to the audit. We understood that this issue had been examined by the auditor in detail for a number of years, concluding that Tesco's controls were fit for purpose. Over the following year we continued to engage with the new CEO and CFO on the strategy for the company and addressing issues of supplier treatment, and with the new chair on board composition and effectiveness<sup>5</sup>. We stepped up our engagement on the company's approach to risk management in January 2016, in a meeting with the chair of the audit committee (appointed May 2015). We raised concerns about the company's risk management systems, particularly for financial auditing.

We discussed initial changes made, including building a new auditing and risk management system that spanned the whole group, and appointing a new external auditor. While welcoming these changes, we highlighted that we would need to wait to see how these improvements were embedded and tested over time.

Recognising that the accounting issues were reflective of broader strategic and cultural issues at the company, we sought an update on how the company was addressing these – particularly supplier treatment – from the CEO and CFO at the interim results presentation in October 2017<sup>6</sup>. We continued to monitor the issue and, in January 2019, discussed the effectiveness of changes, including questioning how the company incentivised and monitored changes to supplier treatment within the organisation with the investor relations director.

We next sought a board-level view of the extent and effectiveness of the changes made at the company in a meeting with the chair in February 2020. We followed up in a meeting with the audit committee chair in May 2020.

## Changes at the company

We have been pleased to see clear changes to the company's culture and ways of working, including changes to employees' incentives to remove those relating to percentage margin improvements and to buyers' responsibilities. These, along with other changes to processes and culture, appeared to have significantly improved supplier practices, with Tesco being ranked highly amongst retailers by suppliers in the GCA external survey<sup>7</sup>.

In our discussion with the chair in February 2020, when we sought a board-level view of the extent and effectiveness of the changes made at the company, the chair confirmed that the company has worked hard to rebuild trust with stakeholders and has reset its ways of working with suppliers. He stated that he believed changes made to financial risk management and audit have been effective and the specific issue of recognition of commercial income was unlikely to recur, although it is subject to continuous scrutiny.

In our meeting with the audit committee chair in May 2020, he confirmed that the changes initiated in 2015 and 2016 were now established and working effectively. This includes robust, centralised processes governing risk management, meaning that risks and opportunities are able to be carefully considered. There is also a culture of transparency, with candid dialogue between executives and the board.

The audit committee chair also confirmed that he was satisfied that the specific issue of how commercial income is booked – which had triggered the initial accounting scandal – is unlikely to recur for the foreseeable future, with quarterly tracking and investigations into drivers should there be material movements. The company's external auditor no longer raises it as a material concern for Tesco, although it remains noted as a key audit matter. Improvements to internal audit and financial controls have also proven effective over time.

He oversees supplier issues and the relationship with the GCA and believes these strengthened relationships have been an asset through the coronavirus crisis. Pandemic risk was on the company's radar and was rapidly escalated, with a swift operational response. For example, it increased available delivery slots from around 590,000 when the UK lockdown was imposed in March to over one million by the end of April<sup>8</sup>.

We are satisfied with the effectiveness of the company's changes, demonstrated through its response to the coronavirus pandemic in 2020. Improved risk management processes enabled a quick operational response, while the company's culture enabled swift decision making. We further informed this view in a meeting with the chief people officer in May 2020, in which we were pleased to hear that the company's efforts to rebuild trust with stakeholders, including employees, have resulted in an engaged and motivated workforce that has enabled the company's response.

### Next steps

The link between strategy, conduct and culture, as well as human capital management and treatment of suppliers will remain important topics for our engagement with Tesco, particularly given the leadership transition to a new CEO and CFO and against the background of the economic and social impacts of coronavirus, which continue to disrupt the retail landscape and present notable challenges and competitive opportunities.



**Amy Wilson**  
Engagement  
EOS

**We continued to engage with the new CEO and CFO on the strategy for the company and addressing issues of supplier treatment.**

<sup>6</sup> See 2016 EOS Tesco case study for more details.

<sup>7</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/721703/GCA\\_Annual\\_Sector\\_Survey\\_2018\\_-\\_the\\_results.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/721703/GCA_Annual_Sector_Survey_2018_-_the_results.pdf)

<sup>8</sup> <https://www.tescopl.com/news/2020/tesco-serves-more-than-one-million-online-grocery-orders-in-a-week/>

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

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## Why EOS?

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