Actions can speak louder than audits

Jamie Stevenson examines why auditors sometimes fail to spot cases of possible accounting manipulation, looking at the example of Tesco, where clear warning signals were flashing.

First, a declaration of interest: criticising auditors for failing to spot accounting manipulation is a favourite sport of mine. For me, after 20 years as an equity research analyst, the words “the group financial statements represent a true and fair view” are in the same category as “the cheque is in the post” and “I’ll still love you in the morning”. Equity analysts are born to pick holes in the assurances given by auditors.

This cynicism goes beyond the outrageous cases such as Enron, WorldCom, Parmalat and Polly Peck, where there was accounting fraud. I am talking about the myriad incidents where the company’s pursuit of profit and share price growth can conflict with transparent exposure of true value.

My favourite UK case of the past decade, Tesco, shows how clear warning signals were missed. Yet amid the complex array of judgments to be made about the value of transactions, assets and liabilities, even the most forensically sharp and challenging auditor cannot spot every looming disaster.

Three former executives at Tesco have recently been charged with fraud. Further, a group of institutional funds has brought a £100m civil suit against the company for alleged offences against the Financial Services and Markets Act in making misleading statements to the market.

Whatever the outcome of those cases (and of the Financial Reporting Council’s investigation of PwC’s auditing), Tesco remains my favourite example of questionable value creation, albeit for a self-indulgent reason. I was not a retail analyst, but from 2005 onwards I was in the sceptical camp. On shopping trips to Tesco, Sainsbury’s, Asda and Morrison, I would ask myself: what is so special about Tesco’s plain-vanilla, food retail formula that gives it margins double those of its rivals?

To illustrate this point, I have used below the three quoted competitors’ financial statements (Asda is excluded since, as part of Walmart, it does not publish comparable statements) to calculate their operating margins, revenue growth rate and return on equity (RoE) over the nine years from 2004 to 2012. By 2010, warning signals were

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Source: author’s calculations
flashing. True, Morrison was catching up on margins and the RoE gap had narrowed, but Tesco still reported more than twice the rate of annual revenue growth and apparently sustained double the operating margins of its closest rival, Sainsbury’s.

The main reason for that narrowing of the RoE gap was Tesco’s excessive investment in unsuccessful overseas operations. Take that away and its UK business was reporting around double the growth, margins and returns of its two direct quoted rivals. It was, as chief executive Philip Clarke subsequently acknowledged (before his departure in 2014), “running the UK business too hot” to fund overseas expansion and keep the growth story alive.

Digging into the internal workings of Tesco turned the warning signals red. On every major performance metric (sales per square foot, like-for-like growth, use of space, etc) Tesco was showing a declining trend from 2007 onwards. Yet earnings per share kept on rising ahead of the sector and right in line with market expectations. It was one of the most carefully managed earnings stories.

Tesco’s bare-knuckle relationships with suppliers – which would turn out to be the source of the £250m half-year profit mis-statement revealed in September 2014 (the total for all periods has since risen to £326m) – were legendary. Indeed, criticism of supplier relationships formed one of the two key findings from the Competition Commission’s 2008 report into the sector as a whole. So it was no surprise when, in January 2016, the Groceries Code Adjudicator criticised Tesco for delaying payments up to 24 months, for failing to rectify promptly data errors leading to under-payment or duplicate invoices, and for putting pressure on its commercial team to prioritise hitting margin targets over dealing fairly with suppliers.

This might make you wonder why market expectations – generated by equity analysts – were so positive. Analysts had started to ask questions. The equity research world was buzzing from 2010 onwards with analyses of Tesco’s extended asset lives, falling depreciation charge, contributions of property sales to profits, rising pension fund deficit and increases in capitalised expenses.

At face value, that looks like an open and shut case against the auditors. Why had they not probed deeper? Were they overawed by the stellar management reputation? (The former chief executive, Sir Terry Leahy, is still a UK corporate hero, having timed his 2012 exit to perfection.) As it happens, in the company’s 2013-14 annual report, PwC did list “recognition of commercial income” from suppliers as its first “area of focus”.

It is also open to question to what extent the auditor’s efforts should be driven by external commentary. That could be never-ending. Equity analysts, especially sell side, are constantly competing to be the first to raise questions. Analysts themselves attract flak for failing to spot warning signs and for over-promoting growth stories to create business, which is why they are equally motivated to identify the threats that others have neglected. There are many FTSE 100 companies about which analysts have raised accounting queries and been proved wrong.

More importantly, if an analyst picks a particular hole in a company’s financial statements and is mistaken, it is not the end of the world. An auditor, however, has to cover the whole range of a company’s transactions, checking them against the relevant accounting standards, and sign them off as compliant. If the auditor withholds an unqualified signature without clear, strong reason, it may be damaging a viable business.

Coming back to the Tesco case, was it really the profit mis-statements that destroyed shareholder value? No. Absolutely not. They are the symptoms, not the cause. The unravelling of Tesco was caused by its wider strategic misjudgment. It pursued superstore size just when shopping habits were switching towards smaller, more frequent visits and Aldi and Lidl were starting to make inroads into the value end of the market. That, plus its misguided overseas expansion, is what destroyed shareholder value at Tesco – not the failure of PwC to pick up a ploy on timing supplier promotion payments to meet management targets.

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Pity the auditor at the mercy of a ruthless, criminally minded client. When Leopold Bloom turns up to audit the accounts of Max Bialystock, a failing New York theatre impresario, he discovers a curious accounting “quirk”. If Bialystock stages a surefire flop that closes on opening night, he can make a fortune by claiming on the insurance. Bullied by Bialystock, the timid Bloom agrees to set up the scam by fiddling the company’s books.

Few auditors would dream of promoting a Broadway musical, never mind one with the nightmare title song Springtime for Hitler. Fewer still end up in jail, the fate of Bloom and Bialystock in Mel Brooks’ 1968 comedy film The Producers. The duo fail to realise that Springtime for Hitler will receive rave reviews as a satirical masterpiece and sell out, night after night.

In the real world, the “Big Four” accounting firms – Deloitte, PwC, EY and KPMG – confront a more prosaic perception issue than the one that faced Bloom and Bialystock. Try as they might, the Big Four cannot shake off the widespread view that they dominate an uncompetitive industry where global audit firms have overly secure rolling and long-term contracts and can get much too close to the clients they should be examining.

“The debate about competition in the auditing market has raged ever since Arthur Andersen collapsed in 2002 after its role in the Enron scandal,” says Oliver Parry, head of corporate governance policy for the Institute of Directors. For an accountant, numbers speak louder than words and the Big Four’s market share statistics in Europe appear, at first glance, to back up the charge that they operate a cosy, semi-closed shop. Audit Analytics, a US research company, estimates that the Big Four collectively control 61 per cent of the EU’s auditing market, covering about 5,750 publicly listed companies. In the UK, there is effectively a “Big Five”, with Grant Thornton and the four accounting majors carving up about 80 per cent of the market, in broadly equal shares (Grant Thornton is smallest with 11 per cent of audit business).

“Increased tendering and rotation of auditors had the aim of opening up the market but, in practice, these reforms appear to have produced further market concentration,” says Liz Murrall, director of stewardship and reporting at the Investment Association, looking back on more than a decade of regulatory initiatives since Arthur Andersen folded.

In June 2016, the EU introduced its latest set of audit reforms, designed to shake up the market and address potential conflicts of interest. Under the directive, big publicly listed companies, as well as large unlisted banking and insurance companies, must tender their statutory audit at least every 10 years and change their auditor every 20 years. The EU directive also sets stricter limits on the non-audit services that a company’s auditor can provide to the same client. Prohibited services include tax and legal advice, and management consulting work that bears on the client’s strategy.

According to Gilly Lord, PwC’s UK head of regulatory affairs, the Brexit referendum victory will have little short- or medium-term impact on the UK government’s implementation of the EU’s audit reform legislation, which is already in place. In a blog on PwC’s website on 24 June, Lord predicted that even after Brexit, “it’s more likely that the UK will continue to apply much of the EU regime in order to maintain market access”.

What remains, however, is the overarching question of whether the EU reforms will reduce what Brussels calls the “systemic risk” of an audit market that “is effectively dominated at the top end by four networks”. According to the Institute of Chartered Accountants in England and Wales (ICAEW), there is a sound reason why larger audit firms are far more successful at tendering for contracts with international companies, and especially with banks, insurers and other financial services companies.

“Bank auditing is certainly specialised, but this is partly thanks to the nature of the work involved,” says Philippa Kelly, of the ICAEW. “Many audit firms don’t have the experience, expertise or capacity to staff a big bank audit.” Her point is underlined by Paul Chisnall, head of financial policy and operations at the British Bankers’ Association. “Banks and insurers are the direct holders of

“Too close for comfort?”

Richard Tomlinson discusses the implications of the Big Four auditors dominating the industry and looks at whether they should face tighter scrutiny from regulators

‘Reforms seem to have produced further market concentration’

‘Many firms don’t have the expertise or staff to audit a large bank’

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价值对他们的顾客，”他说。“在审计师的视角，资产负债表可能与制造商或零售商不同，其中涉及的风险可能更加直接。”

但还有另一个论点，认为主要金融机构的审计师应更紧密地审查，因为如果银行或保险公司失败，对客户和公众的更大风险。

“在2008-09年全球金融危机的高潮上，各大四的执行表现。在英国，至少，最近涉及PwC和Cattles，一家倒闭的约克郡地区消费金融公司的案件，可能是一个预示。“

在2016年8月，财务报告监管机构（FRC），英国的会计监管机构，对PwC处以2.3百万英镑的罚款，加上750,000英镑的成本，在涉及该公司2007年审计的案件中。PwC在其声明中说：“虽然FRC已经承认我们被第三方故意误导，我们认识到2007年审计未能达到预期标准。”

这是FRC对审计公司开出的第二笔最大罚单。然而，对一个中立的观察者来说，即使是PwC的原始罚款3.5百万英镑（经过减免和“和解折扣”）与该公司2015年全球营业额35.9亿美元相比，显得相当小。

“我认为，审计师的罚款并不一定有意义，”Murrall观察说。

一个可能更大的审计案件，回到金融危机，现在正由FRC进行调查。2016年1月，Stephen Haddrill，FRC的首席执行官，告知Andrew Tyrie，议会权力强大的财政选择委员会主席，监管机构的执行委员会正在对KPMG在2007和2008年对HBOS的审计进行“初步调查”。“为什么监管机构选择只看两个“特别元素”中的审计，而不进行全面的“更广泛的审查”？“独立监督”监管机构的调查吗？等等。

在FRC重新审议其先前的结论，只有一个确定的结论。“无论FRC关于KPMG在2007和2008年对HBOS的审计的最终结论如何，财政选择委员会都必须提出更多的问题，”预测Parry。如果FRC采取行动，委员会会问是否还有更多的此类案件，如果监管机构不作为，委员会会想知道为什么。”

更具体地说，坚持不懈的Tyrie正在对审计公司进行调查。就像Springtime for Hitler，但为了更发人深省的原因，Tyrie的秀看起来会继续，继续。

Richard Tomlinson is an international business writer and historian who has written extensively about France. His latest book, Amazing Grace: The Man who was W.G., is published by Little, Brown