Retail & Consumer industry

Q&A: What went wrong at Tesco?

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Tesco says it overstated its half-year profits by an estimated £250m because of irregular movements in "commercial income" – the revenue that it receives from the giant multinational companies that supply many of its products.

Why do suppliers make payments to Tesco?

The UK's grocery market is so competitive, big brands will bid against each other for the best spots on Tesco's shelves.

Some suppliers pay a listing fee for their product to be carried in Tesco's stores, and that fee rises for smaller Express stores where fewer product lines are carried. Brands will also pay to secure a prime position on Tesco's shelves, and to fund certain promotional activities.

These all stimulate volumes of sales. The advantage to suppliers and manufacturers is that the more product shifted, the more efficiently their factories can operate.

What form do these payments take?

The problem relates to the extra incentives, often called "rebates", that Tesco receives from suppliers for hitting a certain level of sales, or for support for promotions, according to two people familiar with the situation.

Tesco and other supermarkets must always estimate halfway through the year how much these rebates will be worth for the full year.

For example, Coca-Cola could offer a percentage discount on 2-litre bottles if 20m of them were sold in a specific period – but it will only pay this rebate if the sales target is hit. Tesco's UK sales volumes have dropped as it loses market share to competitors, so there is a risk that such volume-driven rebate targets could be missed.

"Tesco has been suffering meaningful volume declines for some time, so it is no surprise that suppliers have shifted support from Tesco (and others) to companies that are delivering growth eg. Poundland and B & M," said David McCarthy, head of European consumer retail research at HSBC. "We suspect Tesco may have been booking promotional rebates based on historic precedent rather than on current volumes, although we have to wait for the interims to find out details."

Dave Lewis, chief executive, would not comment on the specifics of this case on Monday but said that "there is an element of promotional support and other contractual elements which are income Tesco receives".

When and how is commercial income recognised?

Typically, the central finance department will send emails to individual Tesco managers, asking them what rebates they expect to receive from their suppliers in relation to first-half trading. This is a judgment made by the managers, who will not necessarily have to provide evidence for their assessment. This means there could be a temptation to be overly optimistic when they estimate the rebates. The risk of this could grow if the rebate numbers are linked to commission or bonus payments.

How much of a grey area is this?

As the estimates are based on an individual's judgment, there is already an element of subjectivity. It then becomes more of a grey area because the estimates are of income that has not yet been received.

An accounting expert at a large bank said: "It's all about receivables, not received. It's not cash in the bank. It's quite judgmental because you might not know the answer yet."

For example, a rebate could be £2m if sales jump 3 per cent, but £4m if sales increase 5 per cent. The manager will not yet know by how much sales have grown, so will have to make an estimate.

Should PwC, Tesco's auditors, have spotted this issue?

Tesco said on Monday that the problems had occurred in its first-half results, which do not have to be audited.

But the issue of how such payments are recognised is flagged in the auditor's report, contained in Tesco's 2014 Annual Report.

PwC highlighted the recognition of commercial income as an area of focus "because of the judgment required in accounting for the commercial income deals and the risk of manipulation of these balances".

The report says: "Commercial income (promotional monies, discounts and rebates receivable from suppliers) recognised during the year is material to the income statement and amounts accrued at the end of the year are judgmental."

The accounting expert said: "It's clearly a bit embarrassing for the auditors, but they'll be able to say that they knew this was a risk and said so in their auditor's report."

Tesco has already referred itself to the Financial Conduct Authority, but what happens next will depend on whether this is a one-off, isolated incident. If Tesco's accelerated recognition of commercial income and delayed accrual of costs is found to be long-running and systemic, it could be problematic for PwC.

In addition, PwC has audited Tesco's accounts since 1983; EU rules require companies to retender their audit contract every 10 years.

Have other supermarkets had problems with revenue recognition before?

Just months after Wm Morrison completed its takeover of Safeway in 2004, it decided to restate first-half sales figures that Safeway had previously issued to take account of new accountancy guidelines on revenue recognition. The restatement implied a like-for-like sales reduction of 2.5 per cent.

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