

THE PATTERN OF FRAUDULENT ACCOUNTING : ETHICS, EXTERNAL AUDITING AND INTERNAL WHISTLE-BLOWING PROCESS

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Abstract

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The ongoing debate in the literature centres on the compromised auditor's independence in consequence of the relevant provisions perceived for non-audit services provided to the audited clients. The accounting scandals that have occurred over the past two decades show the lack of competence and independence of external auditors, who kept quiet in the face of attempted frauds. The case of Tesco represents an undeniable example of the loss of auditor's independence, who failed to detect accounting manipulation confirming the importance of whistle-blowing procedures in disclosing concerns before they become serious problems. When turnover occurs in CEOs it is more likely that a rotation in external auditors occurs as well. Finally, changes in top management enable whistle-blowing actions to be successful, interrupting the organization's dependence on serious wrongdoings and preventing a disastrous ending. The success of whistle-blowing in preventing company failure makes it an effective instrument of corporate governance.

Keywords: External Auditors, Whistle-blowing Process, Corporate Governance, Wrong-doing, Accounting Manipulation, Qualified Audit Report, Top Management, Non-audit Services, Codes of Ethics

INTRODUCTION

The various scandals which have occurred over the past twenty years, involving politicians, business management (who provided fraudulent financial statements) and auditors (who certified that these financial reports were representative of the economic condition of the firms), had, as a consequence, undermined public confidence and investors' trust in Capital Markets.

New and stronger regulations have been required to restore confidence in corporate governance systems in general and in financial reporting processes in particular. Ethical constantly increased in relevance and the implementation of codes of Ethics aims to guarantee public interest protection on the competence and integrity of the accounting profession. In support to law and regulation, the exercise of ethical judgements could help to prevent manipulation in financial reporting, rescuing confidence in financial markets (K.Barlaup, H.I.Dronen, I.Stuart, 2009).

In 2001 and 2002 a series of corporate scandals in the US (e.g. Enron, Worldcom, Adelphia Communications, Tyco International, Xerox), led in 2002 to the passing into law of the Sarbanes-Oxley (SOX) Act.

The focus of the Act has been on improving the quality and transparency of financial reporting as well as interpretation by professional securities analysts. CEOs and CFOs are required to certify that financial statements plus supplemental disclosure are truthful and reliable, that the information given to external auditors is complete and fair (Section 302), that the financial statements comply with statute and fairly report the financial condition and results of the operation (Section 406). Management is responsible for establishing and maintaining an adequate internal control structure and procedure for financial reporting (Section 404) and the annual report must disclose any material weakness identified by management. Furthermore, it attempts to promote more effective business practices through corporate codes of ethics (R.M.Orin, 2008), requiring companies to disclose whether they have a code of ethics for senior financial officers (Section 406). The name of the financial expert on the audit committee must also be disclosed (Section 407).

Many other countries have initiated corporate governance statements and frameworks. For instance, over the last decade in the UK and Ireland there have been a series of reports, beginning with Cadbury Committee in 1991, which recommended that directors "should make a statement in the

report and accounts on the effectiveness of their internal control systems". The Cadbury Code issued in the UK in 1992, aims to improve internal control mechanism setting out the relationship between internal control, financial reporting quality and corporate governance. In the UK corporate governance concerns are related mainly to financial controls and financial reports and it aims to avoid financial losses arising from fraud and/or incompetence. To be compliant with the contents of the Cadbury Code, the accountants were recommended to establish criteria to assess the effectiveness of the internal control systems and auditors were required to develop guidelines on procedures and the form of reports (Spira L.F., Page Michael, 2003).

The Institute of Chartered Accountants in England and Wales (ICAEW) developed an additional guidance on these internal controls, focusing on financial controls. In fact, through financial reporting-guidance for directors of listed companies registered in the UK, directors are required to review the effectiveness of their internal financial controls, disclosing the procedures used. In 1995 the Greenbury Report on directors remuneration was published, which recommended a code of best practices based on accountability and transparency principles promoting remuneration package related to long-term results. In 1998 a combined version of the above reports was contained in the Combined Code on Corporate Governance, which covers all controls (financial, operational, compliance and risk management). In 1999 the ICAEW published the *Internal Control: Guidance for Directors on the Combined Code* (also known as Turnbull Report), to clarify the Combined Code's provisions that directors should, at least on an annual basis, review the internal control systems, reporting the results obtained. The Combined Code was updated in 2003 while the Turnbull guidance was updated in October 2005. In 2010 the Combined Code on Corporate Governance was reviewed and published under a new name, the UK Corporate Governance Code, which is intended to facilitate effective and prudent management pursuing the long term success of the company. The new Code was updated in 2012 and it suggests to FTSE 350 companies to put the external audit out at least every 10 years. Moreover, at least half of the board, excluding the chairman, should comprise non-executive directors (two for smaller companies). Moreover, the board should establish an audit committee with at least three independent non-executive directors (two in the case of smaller companies).

While the USA follows a "rules-based" approach to corporate governance, where companies listed on the New York Stock Exchange (NYSE) must comply with, for example, the Sarbanes-Oxley Act or face fines, penalties and imprisonment, the UK follows a "principles-based approach". The principles-based approach allows a degree of flexibility in adopting the principles provided by the Code. Companies who were still not fully compliant with the UK Corporate Governance Code are required to provide exhaustive explanations to shareholders as to the reasons they choose not to follow the provisions of the Code, adopting a non-compliant position.

The core of the ongoing debate in literature is related to the loss of auditor independence due to

non-audit services provided to clients being audited. The matter of the compatibility between Audit Independence and Management service for the same client was just investigated in 1968 from D.R. Carmichael and R.J. Swieringa. The Authors analyze the topic considering two main points of views: the *case for* and the *case against* performances of both auditing and management services. The first stream considers the Certified Public Accounting (CPA) not deeply related to the business and able to make an objective evaluation against the ability to resist to client's pressure (*e.g.* threat of losing consultant services). Also, because of the relationship established with the client, the CPA could provide the more valuable service. The latest stream affirms that the auditors have to maintain their independence, refusing to be involved in management decisions. The Authors conclude that the consulting relationship could impair CPA independence but it does not mean that auditors have lost their independence.

To investigate the reasons for auditor's loss of independence, a retrospective look over past crises must be carried out.

At the beginning of 1960 the average rate of return before tax on the UK business was around 13% per annum, decreasing to around 4% in 1975 and to 2% in 1980, due to the two petrol shocks which occurred in 1973-1974 and in 1978-1979. In conjunction with low investments in British industries, the inflation rate reached double-digit and unemployment rose as well. To avert this crisis the Government encouraged the growth of the services sector, including the financial industry, which significantly increased its business. Specifically, during the 1970s Banks increased their loan activity (in particular in the property sector) and the speculative activities (*e.g.* engage in derivative instruments) appeared to be more attractive in terms of gains, than traditional manufacturing industry. Secondary banks were deeply involved in these activities. Following the first petrol shock the oil prices quadrupled, demand for property slumped, their prices fell, borrowers were not able to honour their loan payments and several secondary banks, in turn, collapsed. Companies with a long presence in the market collapsed as well. The UK State was obligated to rescue twenty-one institutions through bail-out actions. The crisis that involved also other industry like shipping and insurance, highlighted huge spread in accounting frauds, involving auditors, who missed their role as "watchdog", in detecting and alerting on fraudulent behaviours. In their defence, for a long time, auditors declared that frauds detection and reporting were neither included in their function or their responsibility (Sikka P, Willmot, 1995).

In the 1980s British companies continued to fail because of their inefficiency, causing a subsequent reduction of audit business. The audit companies tried to off-set the reduction of audit fee by non-audit fees, extending in their business in the non-audit market (Sikka P, Willmot, 1995).

The Department of Trade (DoT) decreed that auditor ability to issue an independent and objective report on the real economic conditions of the auditee were constrained by their financial interest in the company. Furthermore, when the work they have audited was previously done by the auditors

themselves as accountants, the independence is more likely to be compromised (Sikka P, Willmot, 1995).

The above reasons made auditors more reluctant to issue the so called 'modified opinion', which reports that financial statements are affected by material misstatements and do not represent fairly the company's financial condition, position and operations.

The collapse of Grays Building Society which occurred in 1978 provided a striking case of fraud that auditors had been unable (or unwilling) to detect during more than 40 years and that became public only after the chairman's suicide. Other cases in which auditors have lost their independence are, for instance, World Com (external auditors was Arthur Andersen), Lehman Brothers (external auditors was Ernst and Young), Enron (external auditors was Arthur Andersen), Adelphia (external auditors was Deloitte), Maxwell (external auditors was Coopers and Lybrand, now part of Pricewaterhouse) and Parmalat (external auditors were Grant Thornton and Deloitte).

In order to restore trust in the independence and reliability of auditing the Auditing Practice Committee (APC) was established. Audit Regulation was also issued by ICAEW, aiming to ensure the integrity of individual accounts. For instance, to prevent small firm's auditing major companies, the guidelines state that the incomes of the audit firm from one client should not exceed 15% of its gross fees (Sikka P, Willmot, 1995).

In the attempt to address the cases of audit failure the Joint Disciplinary Scheme (JDS) was established, that, together with the APC and the ethical guidelines, should provide effective corrective actions in recovering the auditor's independence and objectivity. Because in some countries auditors are allowed to provide audit service only (*e.g.* Germany), in attempting to harmonize audit regulations across European countries, the Eighth EC Directive was issued (Sikka P, Willmot, 1995).

In the 1980s, to contain public expenditure related to the state finance's injection, the UK government promoted the privatization of the major national utilities (*e.g.* British Gas, British Telecom and British Airways) allowing auditing firms to become the most important providers of profit forecasts reports and owners of all information (Sikka P, Willmot, 1995).

Moreover, in the 1985 Companies Act accountants are required to comply with law and accounting standards reporting in a faithful and fair way. The financial statements must to be filed on public record at Companies House. Small private companies must follow the Financial Reporting Standard for Small Entities (FRSSE) based on UK GAAP. The UK accounting requirements are provided by both the accounting standards and the company laws (Fearnley S., Hines T., 2003).

The Financial Services Act 1986 required financial industry operators to give the account service and the Big 4 accounting firms played a key role, increasing both their clients and their services. In that environment non-audit business implied an increase in the competition between the major accounting firms (Sikka P, Willmot, 1995).

Independence is the quality that in a specific and deep manner concerns auditors rather than other professional activities. A conflict of interest could arise among obligations assumed by the auditor (conflict of obligation) and self interest (conflict of interest). A rigorous practice of professional independence enables in the long term the protection of professional standards (S.Gunz, J.McCutcheon 1991).

The 1989 Companies Act, in accordance with the Eighth Directive, provides monitoring and disciplining procedures for the purpose of audit qualifications (Fearnley S., Hines T., 2003). Following the merger and acquisition wave during the 1990s and the fall in earnings in some sectors, the request for audit services decreased. The number of employees in the audit environment decreased as well, due also to the improvement of the developing technology framework. In this situation, auditors were forced to compete on price to caught client firms. In 1987 the wave of mergers and acquisitions involved also the public accounting firms, that changed from the so called Big 8 (Arthur Andersen , Coopers & Lybrand , Ernst & Whinney, Deloitte Haskins & Sells, Peat Marwick, Price Waterhouse, Touche Ross and Arthur Young) to Big6 first (in 1989 Ernst & Whinney merged with Arthur Young to form Ernst & Young) then to Big 5 (in 1998 PriceWaterhouse merged with Coopers & Lybrand to form PriceWaterhouseCoopers)and to the current Big 4 (after the Enron collapse, Arthur Andersen, which audited the company, finished under investigation for obstruction of justice, following the shredding of the document of its audit conducted in 2001. In 2002 Arthur Andersen was closed).

When the capitalism emerged as the powerful system in managing the gains produced in liberalised market, external auditors were expected to provide surveillance and regulations to become part of the corporate governance. The Companies Act 1985 in UK allows auditors to have access to company's books, invoices, files, board minutes and any other documents, without no restriction and any attempt to obstruct their investigatory activities could lead to civil and criminal penalties. The audit failures in detecting Enron and WorldCom frauds insight the beliefs that auditors covered up the accounting manipulations harming depositor savings and leading to investors losses. In fact, they actually maintained as confidential the information gathered during their activities performed for audit purposes (*e.g.* audit contract, audit tender, working papers, management and audit committees correspondence, internal control reports, etc). On one hand, the firms which the intention of making profits, use audits to give advice on mergers, tax and money laundering avoidance and also to sell executive recruitment, internal auditing and financial engineering. On the other hand, external auditors are not able to perform an independent review because they have interests to maximize their profits through "consultancy" audits. The response to audit failures is in reviewing accounting and auditing standards, through ethical guidelines. When the auditor is appointed by the company, the likelihood that auditors will conduct the audit offering non-audit service and becoming part of the auditee organisations due to daily routine of auditing increases (P.Sikka, 2004). The audit

committee should have the responsibility for making recommendation on the appointment, reappointment and removal of external auditors. Moreover, the annual report should explain how the auditor objectivity and independence is safeguarded when external auditor provide non-audit services.

Previous research has investigated whistle-blowing matters, highlighting the factors which constrain whistle-blowers in taking actions, characteristics of wrongdoings and on the relationship among the whistle-blowers, the organisations and the wrongdoings. The most relevant reviews have focused almost exclusively on the public sector (*e.g.* federal industry) leaving unanswered what constrains and what are the effects of whistle-blowing actions in private sector. This article addresses various issues by building theoretical propositions from the case study of Tesco, a UK food retailer who was involved in an accounting scandal in September 2014. This study aims to explore what happens in the private sector when external auditors fail to alerting attempted accounting frauds and a whistle-blower reports the wrong-doing under a change in Top Management. The crucial work question is whether in the private sector the whistle-blowing process could prevent company failure, thus becoming effective mains of Corporate Governance.

The article is organized as follows. Section 1 carries out a review of the literature. Section 2 explains the methodology used. Section 3 reports a brief summary of Tesco's case. Section 4 provides a theoretical framework. Section 5 concludes.

1. LITERATURE BACKGROUND

The accounting scandals which involved giant companies from various parts of the world caused as a consequence the loss of trust in internal control systems. In order to restore public confidence, regulators, within the several constrains, imposed the implementation of quality control standards (*e.g.* International Standard on Quality Control 1), prescribing both ethical and technical accounting principles. The standard aims to ensure that firms establish policies and procedures based on technical and ethical requirements and that its personnel behaviour complies with them. These requirements of ethical principles are also reinforced by auditing standard (International Standard on Auditing). Moreover, Audit standards require auditors to maintain independence from their clients. Nevertheless, under guidelines and generally accepted accounting principles (GAAP), the financial statement may be less representative of the economic events, due to the discretion available to managers in providing the financial statement. Hence, Auditors have the accountability to ascertain and endorse whether the financial statements report the actual economic conditions following GAAP principles. When auditors detect that the financial statements misrepresent the financial position of the firms and managers refuse to implement audit recommendations, auditors should issue a qualified or disclaimer opinion. Historically, a qualified audit opinion often results in a fall in market share price. As a consequence, it appears clear that a conflict of interests could arise between managers who have the responsibility for financial reporting and

auditors who, on one side, must issue an opinion on financial statement and on the other side are hired and paid by the firm for non audit service (for instance, tax services, consulting related to mergers and acquisitions, information systems and human resources). The professional standards of ethics and legal risks should encourage auditors to provide objective judgments, following integrity and ethical principles (H. Ashbaugh, 2004).

The ongoing literature debate between scholars concerns whether the provisions of non audit services impair auditors independence and the debate is still unresolved.

Empirical research shows that to guarantee the independence of auditors and to improve competition within public accounting, rotating auditors is necessary (R.M.Orin, 2008). In fact, prior researchers agreed that larger the economic impact related to the client loss, the higher the likelihood that auditors compromise their independence. Specifically, the higher the income received from the client, the higher the threat to auditors independence in relation to that client (H.Falk, B.Lynn,S.Mestelman,M. Shehata, 1999).

D.B. Citron and R.J. Taffler (2001) teste a sample of distressed firms in the UK between 1986 and 1993 to clarify whether auditors could fail to disclose uncertainties on the future survival of the firm to avoid its bankruptcy. On one hand, their empirical analysis shows that companies that received reports disclosing uncertainties are more likely to fail than companies not affected by such disclosure. On the other hand, the above empirical research shows that the degree of the financial distress leads firms to bankruptcy and auditors to issue concerns disclosure. In accordance with ethical guidelines, audit opinions should provide an objectively and fair view, although its possible consequences.

Common beliefs perceive Ethics as a matter of individual opinion and a topic mainly for religious authorities. Following the Aristotelian approach to ethics, it becomes not only just a matter of private introspection but acquires a public worth. An unresolved question is how commercial activities are related to good life (business ethics). The empirical approach in matter of right decisions could contribute to build the ethical knowledge enterprises (C. Mackenzie, 1998).

Previous research (M.Kaptein, 2004) in the matter of business codes among multinational firms shows that around 58% of the hundred largest companies have a code of conduct. Typically, these codes define the company responsibility towards employees, customers, suppliers, capital providers (*e.g.* shareholders, investors) and stakeholders in general.

Gaumnitz Bruce R. And Lere John C. (2002) investigate into the contents of codes of ethics across various professional business organisations ³

3 American Institute of Certified Public Accountants (AICPA), American Marketing Association (AMA), American Production and Inventory Control Society (APICS), Appraisal Institute, Association for Investment Management and Research (AIMR), Association of Information Technology Professionals (AITP), Chartered Property Casualty Underwriters (CPCU), Financial Executives Institute (FEI), Information System Audit and Control Association (ISACA),

in the United States and find out that in at least 50% of the codes the following ethical statements are prescribed as obligatory: to be honest, obligation to not disclose confidential information (unless legally required to), obligation to avoid conflicts of interest, obligation to faithfully execute responsibilities, obligation to obey the law and obligation not to misreport.

Empirical research aims to create a framework for ethical decision making to identify the ethical actions within the public accounting profession. The most important ability required to the auditor is to recognize an ethical dilemma, evaluating the moral consequences and putting in place the related corrective actions in a professional and conscientious manner. The Ethical code of professional conduct is on one side the guidelines for the auditor and on the other side it legitimises their professional role requiring them to acting in the public interest. The moral make up of auditors and the efficacy of codes of Ethic are under investigation as well. To enhance the level of ethical behaviour it is necessary to hire ethical employees, provide them with ethics training programs and establish an ethical culture. The goal is to identify what represents ethical behaviour and how they must to be an ethical imperative for the public accounting profession (J.F.Dillard, K.Yuthas, 2002).

Empirical research (Tsui J.S.L., Gul F.A., 1996) shows that both personality and ethical reasoning influence auditor behaviour in the case of ethical dilemma. Thus, to enhance the level of ethical reasoning of auditors it may be useful to select them also using personal traits as a criteria.

An empirical analysis was conducted using a sample of Chinese firms to stress the relationship between ethical reasoning, the perceived risk of detection, the perceived risk of penalties and Chinese auditors' ethical behaviours in an audit conflict situation. The empirical results show that, in China, the ethical behaviour of auditors are influenced by individual moral development and when auditors are characterized by a low level of ethical reasoning, they are influenced in their behaviours by the perceived risk of detection rather than the perceived risk of penalties (Gul F.A., Ng A.Y., Wu Tong M.Y.J., 2003).

Scholars investigate the ability of accountants to detect ethical problems, evaluating their ethical sensitivity, through empirical analysis of several personal traits relating to moral judgements (*e.g.* employment position and expertise, education level, gender, income, age, prior and frequency of exposure to the same ethical dilemma. The severity level of ethical issue is investigated as well). Empirical research has produced contradictory results.

The so called "Ethical sensitivity" highlights the auditor's ability to recognize the presence of a moral problem (J.N.Karcher, 1996). To clarify what is ethical from what is unethical behaviour, the American Institute of Certified Public Accounts issued in 1988 the Code of Professional Conduct,

which mentions the Independence of the Auditor as its most important consideration.

Following the Enron debacle and the collapse of Arthur Andersen, the matter of Whistleblowing among external auditors has taken on great importance due to the fact that no one blew the whistle during the accounting fraud attempts. The Sarbanes-Oxley Act enacted in 2002 aims to protect the public interest, those were not protected by auditors.

Though, current codes of ethics do not clarify to audit staff how to blow the whistle on the relationship between the audit senior and the client firm (*e.g.* Enron), to prevent further scandals, protect public and professional interests. Whistle-blowing could oversee the state failure developing an adequate public accountability structure. Therefore, the whistle-blowing is gaining a public interest role receiving more often legislative support, although causing significant costs, in terms of loss of clients and reputational risks for the audit firms (Alleyne P., Hudaib M., Pike R., 2013).

Whistle-blowing occurs when an audit staff member (audit practitioners) reports internally any actual or suspected wrongdoing. In the case of lack of well established and formal procedures that enables the issue to be raised at the right high level inside the audit firm or the client company, the staff member could make the claims externally (*e.g.* mass media, regulators), with significant damage to the organisation and its employees. Hence, it may be preferable to resolve internally the wrongdoing and to support internal reporting firstly (Alleyne P., Hudaib M., Pike R., 2013).

Several factors constrain the bias to blow the whistle, like psychological, situational and structural, cultural (education) and ethical principles, threat of retaliations, type of wrongdoing, presence of group norms and codes of conduct, individual moral's judgements, organisational support, perceived personal responsibility and personal costs of reporting (Alleyne P., Hudaib M., Pike R., 2013).

The definition of whistle-blowing commonly accepted is that provided by Near and Miceli (1985): "the disclosure by a member of the organisation (former or current) of illegal, immoral or illegitimate practices under the control of their employer to persons who are able to effect actions". The whistle-blower can use internal channels (within the organisation, for instance supervisors or other recipients believed to be able to put in place corrective actions to stop the wrongdoing) or external channels (outside the organisation).

The whistle-blowing literature examines what influence individual and situational variables predict that whistle-blowing will occur when situations are perceived to be illegal, immoral or illegitimate (Alleyne P., Hudaib M., Pike R., 2013).

Research conducted across employees of a large military base in the U.S. (Near J.P., Regh M.T., Van Scotter J.R., Miceli M.P., 2004) highlights that the likelihood of a whistle-blowing act is higher in cases of wrongdoing in mismanagement, sexual harassment or any legal violation than in cases of wrong-doing in stealing, waste, safety problems or discrimination. Moreover, the most relevant factors preventing whistle-blowing are as follows: the idea that nothing could be done to change the situation,

Institute of Internal Auditors (IIA), Institute of Management Accountants (IMA), National Association of Realtor (NAR), Project Management Institute (PMI), Society for Human Resource Management (SHRM), Society for the Advancement of Management (SAM).

the cost of the wrongdoing, the low quality of evidence about the wrongdoing and the risk of suffering reprisal (*e.g.* demotion and loss of job assignments). In the USA, some states protect whistle-blowers when they use internal channels only and others when the external channels are used. External whistle-blowing acts are more likely to suffer retaliation than internals. Both American and British law protects the whistle-blowers whether they are faithfully convinced that the wrongdoing affects the public policy. The goals of the whistle-blowers are mainly to stop the current wrong-doings and to avoid their repetition in the future (Near J.P., Regh M.T., Van Scotter J.R., Miceli M.P., 2004). Previous research focused on identifying who blows the whistle, variables that predict retaliations that the whistle-blower will suffer and conditions under which the whistle-blowers are more likely to act achieving the wrong-doing termination. On one side, following the investigation of major cases of whistle-blowing (*e.g.* falsified accounting report in WorldCom, mismanagement report in regard to terrorists issue in FBI, wrong accounting practises in Enron, misrepresentation of the safety of General Motors), the literature agrees in observing or noting the costs associated with the wrong-doing (*e.g.* in terms of career) and the quality of wrong-doing acts as a predictor of whistle-blowing actions. On the other side, several questions are still unresolved, like the types of wrong-doing leading to whistle-blowing, how the seriousness of wrong-doing is related to the effectiveness of the whistle-blowing and how differences among the various types of wrong-doing (*e.g.* financial fraudulent behaviour, mismanagement of information, ineffective leadership, etc) affect the whistleblowing process (Near J.P., Regh M.T., Van Scotter J.R., Miceli M.P., 2004). The benefits of the whistle-blowing are evident when the complaint is real and relevant and it leads to effective change, stopping the wrong-doing. The success of whistle-blowing is achieved when the wrongdoing ends, at least partially, and in a reasonable time (that changes across various situations and persons). The factors influencing the halt of the wrongful practices are: the characteristics of whistle-blower (*e.g.*, his/her credibility, power, anonymity), characteristics of the wrong-doer (*e.g.* his/her credibility and power), characteristics of the complaint recipient (*e.g.* his/her credibility and power), characteristics of the wrong-doing (*e.g.* organization's dependence on the wrongdoing, legal basis for the complaint and the convincing evidence of wrongdoing) and characteristics of the organisation (*e.g.* the climate supportive of whistleblowing, less bureaucratic structure, low organisation power in environment and appropriateness of whistle-blowing). A legal change that will encourage whistle-blowing is actually necessary to allow whistle-blowing to work effectively (Near J.P., Miceli M.P., 1995). A study conducted on the relationship between corporate and professional codes of ethics and employee attitudes and behaviours shows that neither the presence of corporate codes of ethics nor employees awareness of wrong-doing are related to the decision to report observed unethical behaviour (Somers M.J., 2001).

Following the enactment of the Sarbanes-Oxley Act in USA in 2002 and of several corporate codes in

other countries, whistle-blowing policies also have been implemented. In Europe, these policies generally contain the following items: applicability to all employees, an authoritative tone, protection from retaliation, with criminal offences, dangers to health and safety; of the environment, while other types of violations are covered by codes of conduct and/or ethics policies. The contents of whistleblowing policies are strongly related to their effectiveness. Thus, the most important points in European laws and guidelines are the legal protection of the whistle-blower and the presence of internal policies. In particular, in UK the Public Interest Disclosure Act was enacted in conjunction with the Combined Code on Corporate Governance issued by the Financial Services Authority (FSA) in July 2003, which included provisions on whistle-blowing matters. More specifically, although it was not a law, the Combined Code on Corporate Governance provides that the audit committee should ensure that the firms have in place arrangements that allow staff members to report impropriety in financial reporting or other topics. The audit committee has the accountability for the independent investigation on these claims and on appropriate follow-up actions. Hence, the whistle-blowing policy is the mainly instrument in pursuing the effectiveness of the codes of conduct and the employees who monitor and report the behaviours of their peers is one of the most important mechanisms of control (Hassink H., De Vries M., Bollen L., 2007).

2. RESEARCH METHODOLOGY

This study aims to investigate the role of the whistle-blowing process as practices of corporate governance. In particular, by examining qualitative data arising from a case study, the aim of writing this paper is to better understand the relationship between the variables which influence whistle-blowers together with the effects of a successful whistle-blowing action on the future of the company affected by misbehaviour. A qualitative analysis is carried out to perform a comparison among extant theory and a particular example, highlighting contradictory results and addressing gaps.

In accordance with Eisenhardt and Graebner (2007), two approaches could arise: the phenomenon-driven research question and the theory-driven research question. The former occurs when a relevant phenomenon is not addressed by extant literature. The latter takes place when the existing literature does not provide a full explanation about a complex phenomenon.

The goal of this paper is, therefore, to advance existing knowledge on whistle-blowing processes from a case-basis, producing a new theory following the inductive approach. On one side, theory building from cases may be less grounded than empirical research, which is supported by large-scale data that are deemed representative of some population and more generalizable (Eisenhardt and Graebner, 2007). On the other side, previous research on whistle-blowing generates a hypothesis testing over data collected mainly through survey (questionnaires), which suffer from various limitations, such as the inability to report on events which have occurred earlier, or the lack of evidence about the antecedent

behaviour (Near J.P., Miceli M.P., 1985). Thus, a single case study enables an understanding of a complex phenomenon under specific and singular circumstances, which makes the case as extreme exemplar. In other words, qualitative data could offer insights about relevant social process rather than quantitative data (Eisenhardt and Graebner, 2007).

This work analyzes the recent accounting scandal that involved the UK multinational grocery TESCOs, which on 22nd September 2014 declared that its profit had been overstated by £263,000 due to the inaccurate recording of incomes (booked prematurely) over the previous two years.

The sources of information used are as follows: annual reports (archival data) and articles published by the major newspapers.

Matching the results of prior research on whistle-blowing with the observation of the case study (in terms of economic damage for stakeholders and shareholders, judicial prosecution, changes in control and executive power, and accounting fraud), this work develops several propositions, supporting each of them with empirical evidence.

3. THE CASE OF TESCOs

Tesco was founded in 1929 with only one outlet. Over time, it became a leader in multinational grocery and the world's second biggest retailer behind Wal-Mart, enjoying a global brand equity spread in 12 countries across Asia, Europe and America, opening new outlets and acquiring independent shops that could never compete with their scale. In the UK Tesco is one of the so called *big four* grocers, which includes Wal-Mart's Asda, Sainsbury's and Morrison's. In 2014 Tesco was involved in an accounting fraud that procured to Tesco the title of the grocery giant's earnings collapse. The accounting scandal wiped £1.5 bn off the retailer's market value and Tesco experienced the biggest faller in the FTSE 100 index of blue chip companies. The former Chief Executive Officer left the firm in the summer before the earnings manipulation became public. The scandal led to the departure of several top executives with eight senior executives were suspended during the investigation into the accuracy of the earnings stated in the accounting period. More specifically, the Financial Conduct Authority (FCA), successor body to the FSA, investigated the way the grocery giant treated rebates paid by suppliers and whether they were reported in the correct time period. However, the company's pre-tax profit fell 92%, trading profit reduced 55.9% and its market value dropped more than 50% relative to the same time one year earlier. After restating its balance sheet, the company reported the biggest annual loss over its almost 100 year history of £5.74 billion and its market capitalisation dropped to 14.6 billion pounds down from 19 billion pounds before the accounting scandals. After around two decades characterized by uninterrupted earnings growth, Tesco endured the race of on line shopping and growing competition from discounters (e.g. Aldi and Lidl) and upmarket rivals (e.g. Waitrose and Marks & Spencer) registering a decline in its profits and losing market share. Thus, the misstated financial accounts appear to be

a desperate attempt to conceal that profits were in constantly reduction. The previous strategy involving chains expanding by opening new shops which had worked for decades, failed because too many shops also meant less efficiency. The new CEO announced that his cost-cutting strategies would result in the closure of several stores and cutting thousands of jobs. In September 2014 Tesco admitted it had overstated its half years profits by £263 million (because it incorrectly booked payments from suppliers over more than two years), causing the collapse in its market value. On the New York Stock Exchange, Tesco's share price fell by 15% the following day. Subsequently, the American Depository Receipts (ADRs) brought a legal action against Tesco, claiming that the firm deceived investors hiding its true financial position. Tesco ended up being placed under investigation because it misled investors into wrong believing that the firm was performing well and was in good financial health when in fact it was manipulating its earnings by booking deals with suppliers too early. A group of four American pensions and investment funds sued Tesco over its earnings fraud, which caused a collapse in its share in the US market. For instance, among the people providing proof against Tesco, some suppliers complained the company had issued invoice which had not been agreed. Tesco was accused of recklessly overstating profits by the way it booked commercial incomes from suppliers (it was paying suppliers later and taking money from them earlier than was permissible), in breach of the Groceries Supply Code of Practices. A group of eight employees made deals with some suppliers to pay money to have benefits in the financial period. Tesco agreed to pay \$12 million to US shareholders which claimed that its accounting irregularities inflated the supermarket share price, without admission of liability.⁴ Although, the external auditor, PricewaterhouseCoopers LLP (PwC), highlighted the risk of manipulation in the commercial incomes report within the 2014 Annual Report and Financial Statements, the Audit committee and the board adopted the accounting treatment that led to recording of an accelerated recognition of commercial incomes and delayed accrual of costs, savings in the first-half figures for 2014. Flat sales, failed overseas expansion and intense competition from the discounters led the company to significantly overstate its profit forecast. Analysts conclude that the accounting missteps were due to the weakness of internal systems and the company's financial reporting processes, which allowed the internal bookkeepers under pressure from the executive to "cook the books", through the overstatement of interim profits. Sizeable hole in the company's profits emerged within weeks after the appointment of a new CEO, as a result of a whistle-blowing action reporting the dubious accounting practices. In contravention with Tesco Group accounting policies, income was booked early and costs were deferred paying suppliers later. The overstatement of interim profit generated by

⁴Jonathan Stempel (2015), UPDATE 1- Tesco in \$12 mln U.S. settlement over accounting scandal, Reuters Edition U.S. Available at <http://www.reuters.com/article/2015/11/25tescosettlement-id>

incorrectly booked payments from suppliers was brought to the attention of the board by an internal whistle-blower, who disagreed with the above accounting treatment. The Group General Counsel, after receiving an email sent by a member of the finance department disclosing that the food retailing company had overestimated its profit guidance advised the new CEO, who immediately demanded an investigation on Tesco, suspending four senior executives. It was also appointed Deloitte (another Big 4 accountancy firm), to conduct a review and passing its findings over the Financial Conduct authority (FCA). The independent investigation found that the irregularities were worse than anticipated. At the same time, Deloitte found no evidence of personal gains by the managers under investigation.⁵ The law firm Freshfields was also called to examine the company books. On 29th October 2014 it was announced that the UK's Serious Fraud Office (SFO) commenced a criminal investigation. The UK's Financial Reporting Council opened an investigation on the role of PwC and other members of the accountancy profession.

4. THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

H1: When a change in Top Management occurs, the likelihood that a rotation of external auditors will take place as well, increases.

PwC had audited Tesco for 32 years developing a huge and complete knowledge of the company and its sector. It is very difficult to understand how they failed to check and detect the accounting errors as required. Audit committees are required to contribute to auditor independence, while in the case of Tesco this independence appears to be compromised by the fact that the Chairman of the audit committee had worked at PwC.

In the audit annual report of 2014 PwC warned of the risk of manipulation related to the rebates from suppliers and the way in which they were booked⁶.

The Auditors appear have been lacking in independence, expertise and incentive to issue a qualified audit opinion because of the substantial fees received for audit and non-audit services (Prem Sikka 2009). On one hand a large firm like PwC would use skills and knowledge to carry out the Audit of Tesco. However, on the other hand, the failure to detecting this fraud could suggest that the audit team lacked the required competences. PwC earned £10.4 m for its auditing services and £3.6 m for its consultancy services at Tesco plus an additional £200,000 for auditing the group's pension scheme. Moreover, two of the ten board directors of Tesco were previously employed at PwC and one of

them was also at the time the chair of the audit committee. Although PwC issued an additional annual report and warned about the risk of manipulation relating to the aggressive recording strategy (booking revenues early in line with executive forecasts), it did not actually detect the misbehaviour resulting in accounting irregularities. Thus, the audit firm stands accused of gross negligence.

Arising from the fact that a large number of companies have failed shortly after receiving a qualified audit report and because auditors succumb to the threat of the loss of large amount of fees and the related advancement in career, over the past several accounting scandals, auditors have missed the opportunity to guarantee the accuracy and fairness of financial reports (Prem Sikka 2009).

Moreover, the recent financial crisis showed that accounting rules are not strict enough, allowing companies to modify their financial statements (*e.g.* excessive leverage increases liquidity risk or complex financial instruments like derivatives inflate profits thereby hiding losses).

It is widely agreed that it is fundamental that accountants must operate in the public interest, thus preserving confidence in the markets. In other words, accountants are required to comply with code of ethics, operating with competence, integrity and due care. When an accounting scandal occurs, like the case of Tesco, it pulls these principles away leading to unethical behaviours at the expenses of investors. An ethical dilemma could arise.

The scandals also highlighted that PwC had been the Tesco's long-time auditor (since 1983), a situation that exceeded the maximum ten years tenure recommended in the Financial Reporting Council's corporate governance code. New European Union regulations requiring companies to conduct audit tenders every ten years and change their audit firms every two years and this will come to in force in 2016.

The new CEO, after being aware of the accounting manipulation decided to replace the long serving external auditor (PwC) with another from the Big4 (Deloitte).

Whilst the previous Top Management ignored the reported wrong-doing and was reluctant to take on board the warning provided in the 2014 audit report, the new management interrupted the thirty year relationship with its audit firm and investigated the misconduct, through the newly appointed company.

Hence, it can be concluded that when a change in management occurs, the likelihood of dismissing prior poorly performing strategies and halting misbehaviours, increases. Whether or not serious wrong-doings are detected by external auditors, the likelihood of their removal increases as well.

H2: When external auditors fail in their "watchdog" function, the likelihood that employees will blow the whistle rises.

Miceli M.P., Regh M., Near J.P., and Ryan K.C. (1999) found that in the majority of cases, the whistle-blower (being an employee who has the opportunity to observe the wrong behaviour due to his/her job) is more likely to take whistle-blowing action, the more likely she/he is confident of achieving a successful result (termination of wrong-doing). In our case study, a senior manager of the

⁵ Jenny Anderson (2014), Tesco Accounting Scandal Draws Serenity of Serious Fraud Office in Britain, The New York Times, Available at <http://www.nytimes.com/2014/10/30/business/international/anotherbritishwatchdogopens>

⁶ " ISAs (Uk & Ireland) presume there is a risk of fraud in revenue recognition because of the pressure management may feel to achieve the planned results. Therefore, we focused on the occurrence of transactions and whether they were recorded in the period in which the Group became entitled to record revenue".

financial department observed the misconduct of a group of peers that was clearly detrimental to public interests and he decided to blow the whistle in defence of shareholders and other stakeholders. The commonly accepted definition sets out whistle-blowing as the disclosure of illegal, immoral or illegitimate practices by former or current members of the organisation (Near and Miceli, 1985). Whistleblowing occurs when the observer reports to person who has the authority to take corrective actions, interrupting the wrongdoings. Otherwise, a merely informing action is in place (Near J.P. and Miceli M.P., 1996).

With Tesco's accounting scandal, several executive members were suspended (managing director, UK finance director, commercial director and the member responsible for group sourcing), highlighting that middle and Top Management level were involved in the wrongdoing.

In line with previous empirical research (Miceli M.P., Nera J.P., Schwenk C.R, 1991), the case study confirms that the likelihood of an auditor blowing the whistle is affected by the level of hierarchy involved in the misbehaviour. The higher the level involved, the lower the likelihood of auditors issuing a qualified report, due to the fact that a public disclosure of mismanagement could affect the organisation's stability (*e.g.* decline in market share value).

Looking at Tesco's case, the employees appear to have been more likely to blow the whistle than the auditors and replacing the external auditor enabled the fraud to be detected and brought it to management attention.

Miceli M.P. and Near J.P. (1998) find that when observers of illegal, immoral or illegitimated actions have the accountability of their correction, due to their position within the organisation, like Tesco's whistleblower, they are more likely to blow the whistle, by reporting internally first.

Empirical research (Keenam J.P., 2002) shows significant differences across managerial levels in reporting wrongdoings, highlighting that upper-level managers are more likely to blow the whistle, due to less pressure to conform, less dependence on the organisation and due to their greater knowledge and information on the whistleblowing process (*e.g.* where are the recipients). Tesco's case confirms the sentence of Miceli M.P. and Near J.P. (1998). In fact, its whistleblower was a senior manager, with responsibility for corrective actions due to his position and he chose to report internally. While the sentence of Keenam J.P. (2002) is partially confirmed by the case study. On one hand, the former high-level manager (previous CEO) ignored the complaints and was at least in part involved in the attempt of accounting manipulation. On the other hand, the Tesco's whistleblower appeared to know the reporting process well and to be sufficiently independent from the organisation.

H3: When a turnover in Top Management occurs, the likelihood of successful whistle-blowing actions increases.

A cost-benefit analysis of whistle-blowing action is carried out by the observer before undertaking any actions. On one hand, potential whistleblowers are threatened by retaliation actions (*e.g.* denial of promotion and opportunity of training, reassignment to job with less relevant

duties, transferring to a different geographic location, demotion, dismissal, exclusion from meetings, poor performance appraisals, harassment, etc). On the other hand, the benefits of blowing the whistle are related only to the stopping of wrongdoing (Miceli Marcia P., Near Janet P., 1988).

In the case of Tesco, although the whistleblower was ignored by the former CEO, the new CEO listened to him. Thus, it can be demonstrated that when a turnover in Top Management occurs, the prospect of the whistle-blowing being successful increases.

Moreover, Tesco's whistle-blower decided to be identified from the beginning instead of remaining anonymous. Where existing knowledge on the topic are effective (Miceli Marcia P., Near Janet P., 1988), we expect that our whistle-blower was not anonymous because of his power inside the organization based on his competences, good performances and long service.

H4: Turnover in top management breaks up the organisation's dependence on wrong-doing.

Where the organisation depends on the misbehaviour due to the consequently high costs of its termination and possible damage to the organisation (for instance, the misbehaviour could be essential to its survival), Top Management will avoid halting the wrong-doing (Miceli M.P., Near J.P., 1994)

Tesco was the world's second biggest retailer and had long dominated the supermarket industry in Britain. Following increased competition, Tesco had been squeezed by aggressive cost-cutting competitors, such as Lidl and Aldi. In response, it tried to increase its profit by booking some incomes early and delaying the recognition of some costs (so called *cooking the books*). Its profits had been artificially inflated by payments from suppliers misbooked and business costs glossed over. Tesco management succumbed to the temptation to hide or delay the full impact of falling sales, through the above accounting manipulation and giving the market a false picture of itself as a firm in a good healthy state.

Suppliers paid for the chance to get their products well promoted across the supermarket chain's stores, including promotional activities (*e.g.* paying to get a good position in the shelves). That behaviour caused Tesco to come under investigation for allegedly making reckless and misleading statements to the stock exchange. The warning from the whistle-blower that payments from suppliers were being misbooked and business costs were being glossed over, which resulted in misleading statements being made to the stock exchange, were reported to the former management, who were reluctant to take corrective actions ignoring the complaint because of the dependence on the wrong-doing. However, after the turnover in Top Management, the whistle-blower reported his concerns again regarding the financial strategies implemented by the company and the new CEO undertook proper corrective actions, thus interrupting the company dependence on wrong-doing.

In contrast with previous research (Miceli N.P., Near J.P., 2002), which affirms that wrong-doings are more likely to be terminated when they are less serious, occur less frequently or had occurred for a

short period, the case of Tesco, shows that the halting of misbehaviour is not related to its frequency or seriousness, but rather it is related to Top Management's moral values. Moreover, when a turnover occurs, the new Top Management is more likely to stop the wrong-doing rather than the former under whom it started.

H5: The likelihood that whistle-blowing actions will occur appears to be unrelated to common value within the whistle-blower and top management.

The current research stream (Near J. P., Miceli M.P., 1994) has identified a relationship between common values shared by Top Management and the whistle-blowers, and the likelihood of whistle-blowing.

In the case of Tesco, the observer of wrong-doing blew the whistle both under the former and new CEO and in the first case he was ignored while the new CEO halted the wrong-doing. In accordance with Buckley, Conor, Cotter, Derry, Hutchinson, Mark, & O'Leary Conor (2010), it suggests that the whistle-blowers decide to report the misbehaviour because they are motivated by feelings of loyalty towards their organisation as well as their personal reasons and values (impetus to report), even though the expected values of Top Management may differ (*e.g.* under the first CEO).

H6: The personal traits and values of CEOs are predictors of a successful whistle-blowing rather than the organisation size and the seriousness of wrong-doings.

Previous research (Near J.P., Dworkin T.M., 1998) has shown that the process of whistle-blowing is constrained by the degree of independence between the whistle-blower and the organisation and from the type of change required. Specifically, the greater the independence of the organisation from the whistle-blower, the higher the likelihood that complaints will be ignored and retaliatory actions will be taken against whistle-blowers. In large organisations the dependence on an individual is lower than in a small organisation due to his/her ease of replacement. Thus, in large groups the independence of the organisation over each member increases, causing a higher rejection of whistle-blowing actions and of the subsequently retaliations, leading whistle-blowers to use external channels.

Moreover, in the case of serious wrong-doing (measured by the financial resources involved and in the frequency of the misbehaviour) the likelihood that the whistle-blower will be ignored and retaliated against increases as well (Near J.P., Dworkin T.M., 1998).

Finally, existing knowledge affirms that when observers of wrong-doing believe that the organisation is dependent on the misdeed, they are less likely to blow the whistle (Near J.P., Dworkin T.M., 1998).

Although Tesco was a large organisation, in which the degree of dependence on a single employee is lower, the whistle-blower was not ignored by the new CEO. Furthermore, in spite of the seriousness of the wrongdoing, the whistle-blowing was successful (corrective actions were put in place) and no retaliation was suffered by the whistle-blower following him making his report.

The conclusion from a single case study cannot be generalized to the whole population and it is not possible to ignore previous empirical research.

However, from the case of Tesco, it can be observed that the moral values and personal traits of the new CEO seem to be a predictor of successful whistle-blowing actions, even of the organisation dimension and the seriousness of the misbehaviour. Furthermore, scholars (Miceli M.P., Near J.P., 1988) detect that in a large organisation the distance between employees and top management is higher than in small organisations and the flow of internal communication may be more difficult. The Tesco case study, in contrast with the above concept, shows that when an observer decides to blow the whistle, in the public interests and in the interests of the organisation as well, hierarchical matters are not determining. Existing knowledge on the perception of loyalty by the whistle-blower affirms that in small organisations the potential whistle-blower may feel higher loyalty to the organization than in large organisations, preferring to use internal channels, avoiding damage to the firm's external reputation. Conversely, in large organisations where the dependence on employees is lower, whistle-blowers are more likely to use external channels (Near J.P., Dworkin T.M., 1998).

The case of TESCO highlights that the feeling of loyalty interacts with the moral reasoning of the observer to report wrong-doing than to the size of the organisation and, hence, the whistle-blower chose to report internally.

H7: The effectiveness of whistle-blowing appears to be related to the moral values of complaint recipient, rather than to its power.

The recipient of the complaint is the decision maker in relation to the evidence of wrong-doing and they have the responsibility of taking corrective actions and to give a formal response to whistle-blowers.

Previous research (Near J.P., Miceli M.P., 1996) has shown that the success of whistle-blowing is, among other matters, related to the power of the whistle-blower, the power of the wrong-doer and the weakness of the complaint recipients. For instance, a powerful and supportive complaint recipient increases the effectiveness of whistle-blowing.

In the case of Tesco, the complaint recipient was the same in both the attempts of report, but while the former CEO ignored the whistle-blower, the new CEO had listened him. Thus, the effectiveness of whistle-blowing appears to be related to the moral values of the complaint recipient rather than its support/power/weakness.

Moreover, the whistle-blower did not suffer retaliation (at least under the new top management), due to his values being congruent with those of Top Management. In fact, in accordance with Near J.P. and Miceli M.P. (1994) whistle-blowers are more likely to suffer managerial retaliations when their values are less in harmony with those of the organisation.

H8: When a turnover in Top Management occurs, previously ignored reports of wrong-doing are repeated to new management rather than through external channels, albeit of the seriousness of misbehaviour and the quality of the supporting evidence.

At Tesco, the previous CEO established a climate of pressure, adopting stressed behaviour without listening to opposing points of view. Operational grades were required to reach ambitious

target goals, leading employees to push the boundaries from good practice to permissible but questionable practices. That company culture where results come first, led to the departure (either voluntarily or by firing) of the most experienced top managers, leading the board to lack members of management with direct experience of retailing. The only executive director on the board was the former CEO, who also had not any retail experience as an executive, like the other nine non executive directors.

Probably, the Tesco's board failing was due to the absence of non-executives with relevant experience of the supermarket sector. It is difficult to understand why that PwC did not oppose any objections on the composition of the Board of Directors.

When the previous Chief Finance Officer retired his successor was not yet ready to take up and this poor planning of turnover meant a weakness in the internal control systems over the financial statements. After the replacement of the former Finance Director and under the new finance committee, a senior accountant manager reporting to the UK Finance Director became the whistle-blower reporting the alleged wrong-doings to the former CEO, who ignored him. When the new CEO arrived, the whistle-blower brought his concerns to the Tesco general Counsel's attention, which immediately alerted the CEO (Sunday Times). The new CEO listened to the whistle-blower and the new Finance Director and several other directors were suspended.

Miceli M.,Rehg M., Near J.P. and Ryan K.C. (1999) affirm that observers who are more likely to blow the whistle are longer serving, are better educated, are higher paid, perform their job a high level, hold supervisory status and are familiar with the appropriate channels to use. In the case of Tesco, the whistle-blower was a senior manager, who presumably had longer service, was in a supervisory position, was highly paid and was aware of the correct channels to use.

Near J.P. and Dworkin T.N. (1998) suggest that when the whistle-blowers, who report wrong-doings via the internal channels, fail in the first instance to stopping the misbehaviour and are ignored, they will attempt to achieve their aim using an external channel. In contrast, however, the Tesco's whistle-blower repeated his report internally following the change of the CEO.

Moreover, in contrast with previous research (Miceli M., Rehg M., Near J.P. and Ryan K.C., 1999), which finds that external channels are usually associated with a high quality of evidences of wrong-doing, the Tesco's whistle-blower preferred the *direct voice*, although proof of misbehaviour.

H9: The success of whistle-blowing in preventing company failure makes it an effective tool of Corporate Governance.

Empirical research (Sims R.S., Brinkmann Johannes, 2003) shows that a company's culture has strong influence on employees' ethics. Business ethics is not the result of adopting ethical codes, rather it is a question of the real culture within the organisation.

A comparison between the culture prevailing at Enron and Tesco's help us to understand whether and how the whistle-blowing process, halting the

misbehaviour through corrective actions, could preserve the company from failure.

Sims R.S. and Brinkmann J. (2003) in their investigation into the case of Enron attempt to identify which factors drove the dangerous corporate culture of the organisation resulting in its failure. Enron set out the so called "win at all costs" mentality careless it meant that the company had to go beyond the ethical line. Short period results were considered most important and preferable to the long run and employees were encouraged to act independently and be aggressive in their pursuit of higher performances. Employees with poor performances were publicly punished (*e.g.* fired from the company). When a negative earnings outlook concerned investors, to prevent a fall in market value and a downgrade to its rating, Enron booked revenues before they were realized, starting to jeopardize employees' ethical integrity. It was this type of ethical erosion that led to the collapse of the business. Manager's behaviour creates the organisation's culture, capturing the attention of the employees and the managers focus, becomes the focus of the workers. Enron created an arrogant environment, which aspired unsurpassable in terms of results, but at the expenses of the rules. In other words, the organisations leaders adopted a vision of the company excessively based on the short-term and the entire organisation absorbed this sentiment. In fact, in the general beliefs, employees usually observe their managers' behaviours and emulate them, because they perceive their managers' values to be the organisation's values. Creating such conditions for unethical behaviour is mainly related to the personal traits of CEO/CFO. Moreover, high performing employees were rewarded, clarifying to the entire organisation what was considered to be in line with the management's view. Job performances were reviewed in a public event and poor performances were included in an annual "rank and yank". This environment created a group culture, in which employees were required to be loyal to the rest of the group and they did not complain about wrong-doings, because of their sense/desire to be a part of a winning organisation. An internal whistle-blowing occurred in an anonymous form, threatened by retaliatory actions. But the company ignored the complaint. When the whistle-blower's identity was discovered, she was reassigned to other job and her computer confiscated. The CEO, who was also the President, acted in pursuit of his own ambition and greed, hiring employees who intended to share these same values and qualities. He tried to maximize his individual wealth and after his sudden departure he sold his shares. A few months later Enron was forced to restate its balance sheet and the market value heavily dropped. The new CEO tried to change the culture of the organisation, collaborating with the authorities, dismissing wrong-doers, rewarding employees who complied with the stated values, protecting whistle-blowers and creating a strong ethical message designed to influence employees thoughts and behaviours (Sims R.S., Brinkmann Johannes, 2003).

Examining the Tesco story, many similar aspects are revealed.

The previous and long serving CEO was appointed to the board in 1992 becoming the CEO in 1997 until 2011. During his charge he implemented

growth strategies through international expansion and increased market share based on market knowledge (e.g. implementing the Tesco ClubCard loyalty programme). At the beginning of his appointment to the board, Tesco was a market follower of the two leading brand (Mark&Spencer and Sainsbury, the tenth and the first most profitable retailer, respectively). In 1995 the company had become the UK's biggest retailer. During his tenure, the company's market share in the UK increased from 20 pc to 30 pc. He was then criticised because the firm was too successful. In March 2011 he left the company with a performance bonus of £ 8.42 m combined with a pension of £ 18.4 m. He, probably, recognized that it was the right time to leave his post, subsequently enjoying a lucrative new career as a "business guru".

His successor had joined at Tesco in 1974 as a schoolboy, while his father was also working for the company as a store manager. In 1998 he was appointed to the Board of Directors and in 2011 became the new CEO. In summer 2014 he was preparing to celebrate his 40th year at the company with a party in central London when was announced his departure.

The issue is whether the problems affecting the retail giant derived or were otherwise related to the strategic decisions undertaken by the former top manager. His growth strategies could have had their own negative economic consequences (e.g. too many shops becoming less efficient) in terms of lower sales, manifesting during his successor, who failed to resolve those inherited inefficiencies. Pressure from competitors engaging in an aggressive *cost-cutting war* and the rise of internet shopping, led Tesco management in an accounting manipulation attempting to paint a better portrait of its financial health, by implementing these unbalanced strategies (e.g. supplier arrangements). Their overconfidence led management to be overly confident resulting in overreach. Tesco's expansion was unlimited and it began spreading overseas (US, China, Japan). However, by 2011 the supermarket was losing ground and it was forced to close stores in the US and Japan.

Before the accounting fraud was made public, both the CEO and CFO left the firm. Once the investigation into the accounting scandal commenced, the payouts to the CEO and CFO were frozen pending the completion of investigation. This step was taken anticipating that the company should reclaim bonuses from executives, as a result of overstatements.

This is an example of a new tendency to reclaim payments made to executive with subsequently discovered unethical behaviour which has arisen.

Both Enron and Tesco's management adopted a culture that was excessively results orientated, at the expenses of its rules and code of ethics. Whilst in the former case, the whistle-blower was silenced and isolated, in the latter case, without the removal of the CEO, it is possible that the company could even have ultimately failed. As it happened, because a change in the top management took place, a new CEO was installed, who did not ignore the complaints and the whistle-blowing was successful. It is arguable that the whistle-blowing significantly had prevented a disastrous result for the company.

The above reasons suggest that companies should be well advised to adopt an effective whistle-blowing process, thereby improving corporate governance, more effectively addressing potential mismanagement, financial frauds and any criminal activities (Near J.P. and Dworkin T.M., 1998).

On one side, the whistle-blowers may be viewed as helping the organisation, but on the other side they may also appear to be "trouble makers", revealing wrong-doing otherwise not reported (Dozier J.B. and Miceli M.P., 1985). Positive aspects of facilitating the use of internal channels include a reduction in the number of lawsuits and their related costs, receiving reports on wrong-doing before they get too extreme (e.g. illicit behaviour) and reducing the level of conflict between employees who blow the whistle and the organisation taking retaliatory actions (Near J.P. and Dworkin T.M., 1998).

Hence, whistle-blowers could be viewed as a means of improving the effectiveness of the organisation via their reports and it may be useful for firms to create a clear whistle-blowing process in order to benefit from internal disclosures, before situations get out of hand and result in external disclosures.

CONCLUSION

Tesco is Britain's most popular grocery and retail megastore and it was involved in an accounting scandal after booking some incomes too early and delaying the recording of certain costs beyond the date they were incurred (so called "cooking the books"). The scandal has greatly damaged the reputation of the world's second biggest retailer and the overstatement of its profits caused a permanent damage to the value to shareholders. The issue is whether the accounting errors were accidental or a deliberate effort to manipulate the results, inflating the company's profits at a time when it faced increased competition. The scandal led to the suspension of several senior executives and the company ended up being placed under investigation by the Financial Reporting Council (FCR). It received claims from investor lawsuits both in Britain and the United States, for its conduct.

Although, the external auditor had been auditing Tesco's accounts for the previous 32 years, it failed in its role as "watchdog", neglecting its responsibilities to ensure to stakeholders (shareholders, customers, investors, suppliers, employees) that financial statements report the real condition of the company. For this reason, the new CEO has replaced its auditor PwC after such a long relationship.

In the Tesco case it was a member from within the organization rather than external auditors, who blew the whistle, confirming that it is frequently the employee who observes the wrong-doing that decides to take action against harmful behaviour, rather than an appointed watchdog.

Indeed, the effect of whistleblowing on organisational wrong-doing has become the subject of increased focus, due to the highlighted recognition of the relationship between national security and the strength of the economy (Miceli M.P., Near J.P., 1993).

This case study concludes that the whistleblowing process has become an important instrument of Corporate Governance, supplementing a function which external auditors were previously expected to perform, prior to becoming economically dependent on their clients (*e.g.* fees for audit and non audit services). In other words, the whistle-blowers play a significant role in highlighting concerns, thus, whistle-blowing is an important element in a healthy corporate culture and is crucial also to organisational culture, which must encourage people to report concerns.

The case study investigated in this paper shows that when a change in the Top Management (CEO) occurs, whistle-blowing is more likely to be successful, interrupting the malpractice started under the former management (irrespective of its seriousness). In fact, the previously ignored report has been considered by the new Top Management, halting the misconduct. Changes at the head of the organisation as well as the rotation on a silent external auditor permit the organisation to break it's on the misbehaviour. The effectiveness of the whistleblowing appears to be related to the moral values of the complaint recipient (*e.g.* new CEO) rather than his power, as affirmed in previous research. Hence, the personal traits and values of the CEOs can be considered to be predictors for the success of whistle-blowing.

Many findings set out in previous research into the subject of whistle-blowing (*e.g.* Micely and Near) have resulted from analysis carried out across federal departments, involving examining federal employees. Hence, some of these previous findings may not be applicable to the private entities, like in the case of Tesco.

The most important lesson from the case of Tesco is that the effectiveness of whistle-blowing can help to prevent company failure. Hence, whistle-blowers can be viewed as an effective tool of Corporate Governance, meaning it may be useful for the organisation to create a clear whistleblowing process in order to advantage of internal disclosures.

Finally, it could be argued that under a principle based approach, like in the UK's, more opportunities for less conscientious directors (*e.g.* hubris CEO or narcissistic with tendencies to Machiavellian behaviour) to mislead the board, than under a rules based approach, where behaviours are clearly defined. The case of Tesco highlights that without the UK Corporate Governance Code being legally binding, as the Sarbanes-Oxley Act's, and in the absence of clear sanctions or penalties for companies which fail to comply, many of them are ignoring the Code's provisions. In other words, an approach based on voluntary compliance means that the effectiveness of a company's corporate governance suffers from a major weakness. These practices together with poor corporate governance result in companies being more likely to be involved in accounting manipulations.

In other words, in a context in which ethics of the individual and consequences of the top management actions are deliberate, best principles without proper ethics of the individual will not cause any changes.

To prevent manipulation in Financial Reporting, rescuing confidence in financial markets both the

laws/Regulations and the exercise of ethical judgement are required.

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