AUDIT &
ASSURANCE
FACULTY

AUDIT INSIGHTS
RETAIL

BUSINESS WITH CONFIDENCE

icaew.com/auditinsights

ABOUT THE AUDIT AND ASSURANCE FACULTY

ICAEW's Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

Through *AuditFutures*, the faculty has created a space to ask big questions about the future of the audit profession. It convenes stakeholders who normally do not talk to one another and aims to create opportunities for dialogue and for collaborative and creative solutions to emerge. In partnership with the Finance Innovation Lab, we are building a movement for a wider behaviour change and we are developing innovation projects for systemic effect.

Through the *re:Assurance* initiative, the faculty is finding out where assurance services over business information, such as quarterly reports or key performance indicators, could strengthen markets and enhance confidence; asking how the International Framework for Assurance Engagements can be applied and developed; and answering demands for practical guidance with publications such as *The Assurance Sourcebook*.

The faculty's Audit Quality Forum (AQF) brings together auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in the independent audit.

For more information on the Audit and Assurance Faculty, the current work programmes and how to get involved, please visit www.icaew.com/audit. To learn more about *Audit Insights: Retail* and *Audit Insights*, please contact Ruth Ward at Ruth.Ward@icaew.com, or on +44 (0)20 7920 8639. For all press enquiries, please contact Kirstina Reitan at Kirstina.Reitan@icaew.com or +44 (0)20 7920 8607.

ISBN 978-0-85760-659-4

AUDIT INSIGHTS
RETAIL

FOREWORD

Audit is a public interest activity. Audit reports build confidence in financial statements, and give credibility to companies, and comfort to their stakeholders. Companies also benefit from the insight that auditors have into business processes and the wider market environment. *Audit Insights* is an opportunity for auditors to bring their knowledge of a market sector to the public, capturing more of the audit value for the public interest. Shared insight and observations have been brought together, in an environment that protects client confidentiality, to produce this first report.

Audit Insights: Retail has been drafted by a group of audit experts from the six largest audit firms based on their many years' combined experience working with retail clients across the UK and internationally, and based on their current involvement in planning and delivering audits in the sector. Their sketch of the sector landscape is highlighted by carefully chosen flags, marking out the most immediate areas of interest. This report seeks to explore issues that may not have reached an audience outside the retail sector, and to bring forward the trends and issues that interest the auditors and affect every retail stakeholder.

This report has been drafted at a time when the retail landscape is shifting at an ever-increasing pace and when retailers face a continuously evolving set of challenges and opportunities.

Levels of discretionary spend and consumer confidence have become a daily topic of conversation and speculation. Our macroeconomic climate continues to weigh on consumer demand and influence consumer behaviours.

Retailers face an increased amount of volatility both in demand and in supply and globalisation means identifying and successfully executing on the right footprint for their brand.

Many retailers have experienced tough trading conditions in 2012, particularly on the high street. This was compounded over the Christmas period by continued consumer cautiousness. The desire for bargains, and the timing of Christmas itself, pushed spending later and it is unlikely that the busy post-Christmas sales will make up the balance – certainly not at a margin level.

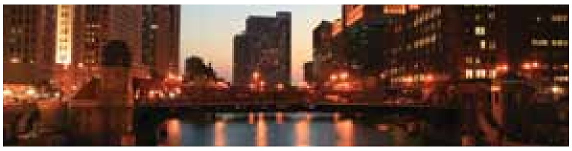
Although the retail outlook is, at best, modest and 2013 is likely to provide more of the same, there are many successful retail businesses rising to the challenge of what is, for now, the new norm.

EXECUTIVE SUMMARY: THREE FLAGS FOR THE RETAIL SECTOR

The UK retail sector is a significant component of the national economy, employing around 3 million people and generating 8% of the UK's GDP. This report is designed to focus attention on the specific issues in the current landscape that auditors find most interesting, and think most relevant to investors, policy-makers, and other retail stakeholders.

FLAG 1: RETAIL IT SYSTEMS AND DATA MANAGEMENT

- To the surprise and frustration of executive directors entering the sector, many retailers' IT systems are underdeveloped. Over the past few years the rise of digital sales channels has revealed the value of customer data management and analysis and spurred some retailers to improve their systems.
- Investment in IT and data management may not be easy in the current economic environment, but holding back is likely to prove a false economy in the long run.
- The practical impact of underdeveloped systems includes increased difficulty in understanding profit drivers by channel, in meeting the challenges posed by global supply chains, and in managing working capital across the business.



FLAG 2: THE RETAILER'S PROPERTY PORTFOLIO

- The changing retail landscape is driving changes in retailers' store strategy to align with changing consumer behaviours. The purpose of store use is increasingly flexible.
- Many retailers have not yet taken decisive action to address their property portfolios and until this happens auditors can expect to see onerous lease provisions, dilapidation provisions and fixed-asset impairments remain common features of the retail audit.
- When considering the value of the property portfolio to their business, retailers face a challenge in terms of understanding the value of store sales contrasted and combined with the value of online sales.

FLAG 3: KEY PERFORMANCE INDICATORS IN RETAIL

- Like-for-like sales figures, the most prominent key performance indicator for the retail sector, are not comparable on a consistent basis and in current market conditions have a reduced correlation to bottom-line profitability.
- Greater transparency around the method used to calculate like-for-like sales, for example disclosure of calculation methods alongside the results, would benefit retailers, investors and consumers alike. Could retailers develop an agreed calculation standard?
- Concern about ethical issues, in particular climate change and resource management, is likely to drive regulation that requires increasing levels of sustainability reporting. Regulators may not be aware of the difficulties posed by ageing data management systems, and requirements may be challenging for retailers who have not historically collected sustainability data.

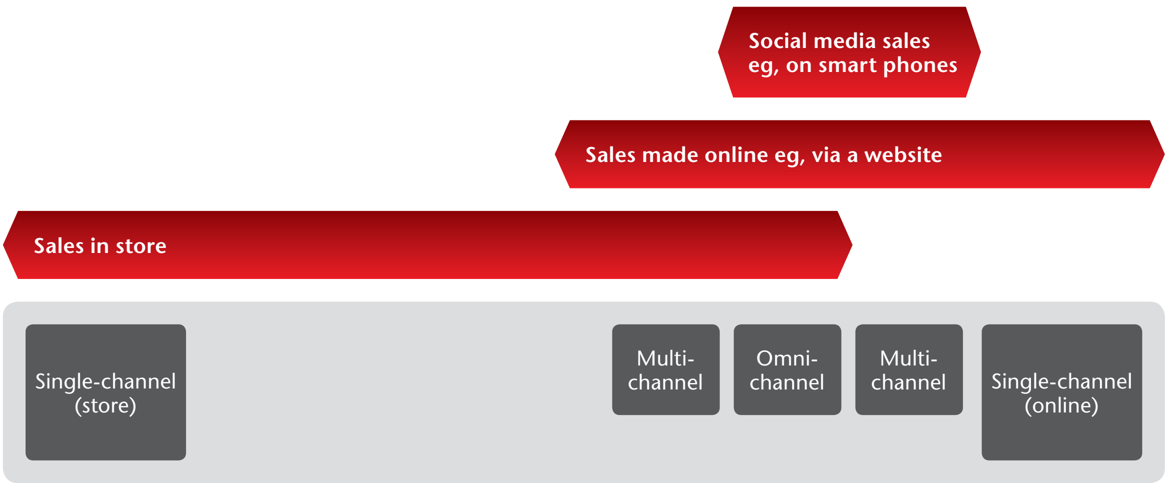
ALL CHANGE, PLEASE: A REVOLUTION IN RETAIL

The way the retail sector operates has undergone a seismic shift over the past decade. Social change driven by technology and the proliferation of channels enabled by advances in technology and fulfilment capabilities, have created a revolution in the standard retail business model. A decade ago, auditors saw their clients experimenting with internet business and e-commerce. Now digital platforms, in all their guises, have become core to the basic retail business model. The goal for many traditional retailers at present is to achieve a successful retail proposition backed up by the right sales channels, which may mean omni-channel retail.

We have moved from a product-led to a consumer-led world and changing consumer behaviours, including the bias towards trusted brands and the 'flight to value', have meant that retailers have had to focus on the right brand positioning as well as the appropriate discounting strategy. Social media have increased the collective consumer power over brands with immediate feedback in the public domain.

The internet is not replacing physical stores, but has changed the way that high-street retailers operate. Although only 10.8% of retail spend by value was online in November 2012, the importance of this channel to customer attraction and retention in a multi-channel environment will continue to increase. The value of internet sales grew by 8.1% year-on-year in November, compared to 1.5% growth for the retail sector as a whole.[1] Online continues to have double-digit growth rates versus stagnant bricks and mortar. However, with brick and mortar still expected to be the dominant channel in the longer term and internet retailers considering

Figure 1: The retail sector spectrum



New technology has increased the number of channels through which retailers can reach customers and make sales. Those using a single outlet, whether a store or a website, are described as single-channel retailers. Combining more than one outlet creates a multi-channel retailer, and has become increasingly common. Many of those with the resources and the reach are now working towards omni-channel retail, a position where they are able to exploit all the available channels to reach customers.

1 Data derived from the Office for National Statistics release Retail Sales, November 2012. See www.ons.gov.uk/ons/rel/rsi/retail-sales/november-2012/index.html.

physical locations, the interplay of these once polar opposites will continue to shape the future of retail. Increasing costs of operating stores, changes in consumer behaviour and technology all mean that retailers will need to continue to consider the number and position of their stores in the future, and face the challenges (and opportunities) of restructuring their property portfolio.

This dramatic change in the landscape is taking place against the background of difficult economic times. Retailers have been forced to juggle the demands of survival in the present with the need for investment in the future, and survival will continue to be a fundamental concern for many stakeholders as well as the businesses themselves, following the key Christmas trading season.
A few common characteristics create a particularly dangerous situation for some retailers, denying them the flexibility to respond to changing circumstances.

The future of the business as a going concern is always a key focus for the auditor as well as other stakeholders. As auditors, we would always encourage full transparency on trading situations and forecasts with all parties involved, to maintain confidence. This includes banks and, crucially in the current climate, an understanding of the reliance that suppliers may be placing on the ready availability of credit insurance.

Changing business models give rise to a changing assessment of risk for auditors.
Assessing risks at the start and throughout the audit process, reviewing retail financial results against the environment, designing tests, drawing conclusions: every aspect of the audit process depends on an understanding of what is typical for the sector, and what is unique to each retail client. Each observation raised in this report is best understood in the context of this tension, and the tension in the sector between change and the challenges posed by change.

FLAG 1: RETAIL IT SYSTEMS AND DATA MANAGEMENT

IT systems in retail are only now catching up with what is already commonplace in other sectors. Many retailers' IT systems have historically been developed in-house resulting in a diverse and often inefficient architecture. Investment in IT often came after investment in stores so that integrated IT systems and controls, which have appeared in other industries have until recently not been prevalent in retailers. The situation across the sector now is one of varying levels of development and opportunities remain to be exploited. The underinvested state of IT systems is still a common cause of surprise and frustration for those executives entering the retail industry from other sectors.

While the imperative for developing IT systems in the recent past has been largely driven by the need to seek efficiencies and the opportunity to improve controls, the move toward online retail has now provided greater impetus. As online front office systems have been introduced retailers have taken the chance to review their overall IT strategy. Moreover, better and more integrated IT systems are more able to produce data that provides retailers with the information and analytical tools to run increasingly complex businesses.

In the current difficult economic climate, many retailers may not find it easy to make significant capital investment in IT, despite the risks of making do with less developed and sometimes manual systems. Some retailers are now rethinking or replacing their customer-facing systems to allow for the full multi-channel experience. Others are making do with existing systems, delaying the need to make costly investment and take on the risks of transition. This is likely to prove a false economy as retailers which do not adapt and embrace the opportunities of the changing environment may struggle to stay competitive. Furthermore, a lack of access to robust data increases risk across the business, exacerbating other difficult issues, as discussed in the later sections of this report.

Four elements of IT improvement:

- Basic efficiencies: gaps in IT that lead to inefficient manual processes are identified and addressed, leading to reduced overheads and less wasted time.
- Strong controls: controls are robust enough to support the production of reliable financial data, whether to be used inside the business or externally.
- Security and reputation: key data, such as commercially-sensitive information, is kept secure and up to date, avoiding the reputational damage associated with data leaks.
- Data monitoring and analytics: the capacity is developed to monitor customer shopping habits and understand needs by channel to inform business strategies.

WHAT DO GAPS IN IT AND DATA MANAGEMENT MEAN IN PRACTICE?

Without relevant data, retailers will not be able to fully understand what gives rise to profits across different channels. IT systems that support data analysis at a customer and store level, and allow retailers to follow inventory through the system, can inform the decisions that are key to success in retail. For example, a solid assessment of the viability of physical stores is vital to support a reduction in the property portfolio (see further discussion under *Flag 2: The Retailer's Property Portfolio*). Robust estimates of the interaction across each part of the business will help retailers understand the value of cash generating units and report accurately on their operating segments, keeping stakeholders informed.

A better understanding of the factors that give rise to profits could help retailers to make more efficient use of resources and identify their most profitable products. This in turn will help improve pricing strategies and target promotional activity to drive profitable growth.

Global supply chains and rapidly shifting markets pose a challenge to retailers in terms of recognising, tracking and valuing their inventory. Auditors naturally have an interest in encouraging businesses to strengthen the financial data that flows in to the annual accounts, and accurate inventory valuation is a key focus in retail. Robust data benefits stakeholders who turn to the accounts for an understanding of the business, but it also benefits the internal decision-making process. The same systems that produce financial information for the annual accounts contribute information used to support decisions. Accurate and timely data will also greatly assist retailers in keeping lenders informed and convinced of their likely future performance.

Retailers may not have detailed control over how much of their working capital is tied up at any given time. In a challenging economic climate, when adapting to new business models, the ability to actively manage working capital and make the best use of cash is likely to prove a critical success factor. As customers increasingly look to the internet and other non-traditional sales channels, strong internal data systems will allow different aspects of the business to work together more effectively. This includes inventory management, supplier relationship management, and efficient processing of orders and payments.

Benefits of strong internal data systems for supply chain management:

- Visibility of supplier payment performance at a transactional level to identify any deviations from payment due dates.
- Better use of approved supplier lists including at store level.
- Exception reporting, for example reporting inconsistencies between systems.
- The ability to categorise suppliers based on spend and payment performance, which can be used to support negotiating positions.
- Structured payment runs with appropriate levels to trigger automated execution.

FLAG 2: THE RETAILER’S PROPERTY PORTFOLIO

The British Retail Consortium’s Monitor found that the national town centre shop vacancy rate reached a new high of 11.3% in October 2012.[2] Primary high streets, top-end shopping centres and retail parks continue to present a picture of security and these retail properties have maintained their value throughout the challenging economic conditions. It is secondary and tertiary high streets, along with older shopping centres and retail parks, that have suffered. The government’s decision to establish the Distressed Retail Property Taskforce in October 2012 is a further sign of the scale of the problem.

The changing retail landscape is driving changes in retailers’ store strategy that reflect what customers want. The high level of shop vacancy reflects the demise of some retailers, but also reflects new approaches to store purpose and the role of the high street. Retailers are taking a more flexible approach to physical stores, making use of pop-up stores, of click and collect sales channels, of smaller properties in carefully chosen locations as showcases or convenience stores. Many, however, are still inclined to focus too much on the results of individual stores, and often forget to appropriately allocate central costs, leading to a potentially misleading assessment of profitability across their stores.

Many retailers have not yet taken decisive action to address their property portfolios. Retailers are acutely aware of this issue but are struggling to find commercially acceptable solutions to exit contractual lease obligations and/or commit cash to pay the premium to exit leases. For many, there is no easy solution. The restructuring of store portfolios will vary depending on market segment, but significant reductions could take place in some portfolios. This issue, along with the upward-only rent reviews and increasing rates, will continue to be a mill stone for many in the sector for some time to come. From the auditor’s perspective this will also manifest itself in onerous lease provisions, dilapidation provisions and fixed asset impairments which will continue to be common features of retailers’ accounts over the coming years.

Accurate and timely data may put retailers in a position to negotiate lease incentives in the current market, but these may not be immediately apparent to external stakeholders considering the financial statements. Landlords are also feeling the pinch as their properties fall in value, and may be willing to negotiate attractive rent-free periods and other benefits for retailers. Those with reliable and timely property and profitability data at hand will be able to make the most of these opportunities. However, external users of retailers’ accounts should be aware that lease incentives such as rent-free periods may not be as easy to identify as other property accounting entries. Impairments to property value, or provisions against dilapidation, are visible by their size and nature. Lease incentives may be accounted for across part or the whole length of the lease term. The resulting changes in the lease charge and balance may not be immediately apparent, giving the short-term cash benefit a misleading appearance.

2 Data derived from the BRC/Springboard footfall and vacancies Monitor Aug/Oct 2012. See www.brc.org.uk/brc_news_detail.asp?id=2330.

Optimising the property portfolio:

- The property portfolio needs to address changing consumer demand and complement digital channels.
- Retailers will need to continually assess overall strategies as stores change to support a flexible portfolio.
- At every lease renewal there is a chance to further rebalance the portfolio, and to consider whether stores should be moved, resized, or closed.
- Retailers should also be aware of the financial statement impact of, for example, the allocation of central costs, particularly when looking at impairment.

Retailers face a challenge in understanding the value of store sales against, and alongside, the value of online sales. Stores no longer operate in isolation but are integral to the multi-channel experience. Even if data systems are good, how do you measure how consumers behave when they use the store to simply browse and then shop online? This also presents a challenge from an accounting perspective. How do you estimate the value of a cash generating unit or operating segment, such as a store or group of stores, when it is not clear where sales are generated? Retailers, their accountants, and their auditors must make judgements about the nature of consumer activity in the new landscape.

FLAG 3: KEY PERFORMANCE INDICATORS IN RETAIL

Although auditors do not give an opinion over key performance indicators (KPIs), they have a strong interest in what is reported. The systems and calculations used to produce currently unaudited KPIs often overlap with those used to populate the audited accounts. The stakeholders who use the annual accounts, relying on the audit opinion, often also make use of KPIs. Another reason auditors have an interest in KPIs is as an indication of the strength, success and resilience of a company as part of a going concern assessment.

KPIs are affected by the weak IT systems and data management discussed under the first flag of this report, as retailers face challenges in collecting and analysing relevant information. The changes to business models and property portfolios discussed under *Flag 2: The Retailer's Property Portfolio* may give rise to changing needs for KPIs. Two separate areas of interest are considered in this context: like-for-like sales figures, currently the most prominent indicator for the retail sector, and the increasing interest in sustainability, which may lead to retailers reporting against new indicators to meet regulatory requirements.

LIKE-FOR-LIKE SALES

Like-for-like sales figures are not prepared on a consistent basis, despite prominent reporting. Retailers use their judgement to calculate movement in like-for-like sales by identifying and removing any distorting elements from the calculation. There is no standard basis for calculating like-for-like sales figures, nor is there any standard agreement on what factors should be removed as distortions. Figures may not be calculated in the same way between different retailers, and the calculation may change from year to year within the same business. There is also no consistency in how the methodology used to calculate like-for-like figures is disclosed in places such as annual reports, or other releases of information.

The nature of like-for-like figures is understood across the sector, and professional investors will already be aware that they may not be comparable. Without an understanding of the adjustments and judgements in each case, however, the wider public may place greater significance on comparisons between like-for-like sales than is warranted.

Factors that may lead to stores being excluded from like-for-like sales:

- Stores undergoing a refit (adjustments to floor space below a chosen threshold, for example 5% of the original space).
- Stores undergoing a resize (adjustments to the floor space above a chosen threshold, for example 5% of the original space).
- Stores due to be closed in the near future (for example, within a fortnight of the date on which the like-for-like sales figures are calculated).
- Stores suffering from a disruption to trading judged to be a major disruption, for example:
  - flood;
  - fire;
  - roadworks outside leading to significantly reduced footfall;
  - town centre redevelopment;
  - a significant competitor opening a store nearby; and
  - any other disruption backed up with evidence deemed sufficient by the retailer.
- Adjustments based on the estimated impact of major events considered to be one-off (eg, the London Olympics, disrupted tourism due to volcano eruption).

As can be seen, a significant element of judgement is employed to determine which stores should be excluded from the figures. As there is no standardisation, the guidelines to support these judgements vary from one retailer to another, and they are seldom disclosed.

The rise of online retail presents a new challenge to the use of like-for-like sales, increasing the factors involved in calculation. Some retailers have chosen to develop separate like-for-like measures for internet sales. Given the challenges posed by IT systems for some retailers, as discussed earlier, it is likely that these will also take widely divergent approaches and serve to confuse the picture still further.

Challenges to data collection and processing, discussed earlier in the context of data systems and property management, are also challenges to retailers assessing key performance indicators. The fundamental judgements required to develop an approach to like-for-like sales in each period depend on a fully developed understanding of sales activity across the business. One reason for the variety in like-for-like calculations may simply be the variety between the systems and range of data available to different retailers.

The core relationship between like-for-like sales and profitability has changed due to increasingly widespread deep discounting. Sales numbers can be pushed at the expense of profitability, by aggressive discounts that may prove harmful to the business in the long term. Retailers seldom link data on profitability, such as movement in profit margins, to like-for-like sales. Stakeholders without specialist knowledge about the sector may get a distorted picture from the published figures.

As the nature of the retail sector changes and retailers move to considering several integrated sales channels, now is the moment to move towards greater transparency across the sector. Investors, customers and retailers would all benefit from disclosure of the method used to calculate like-for-like sales, as this would facilitate comparability between retailers.

Could a standardised method of calculating like-for-like sales be developed? Other sectors have found it possible to create a standardised basis for calculation for their most significant key performance indicators. If greater transparency could be achieved as a first step, it might open the way to achieving greater consistency as well. A standard method of calculating like-for-like sales would create a far more reliable tool for decision making, both internally and for external stakeholders.

SUSTAINABILITY KEY PERFORMANCE INDICATORS

Concern about climate change is likely to drive regulation that requires increasing levels of sustainability reporting. A recent example is the introduction of mandatory carbon reporting requirements, discussed in detail in the box below. Currently sustainability reporting is inconsistent and under-developed across the sector. Accurate and timely sustainability data may not be available to many retailers where there has been no historical need to collect this information.

Mandatory Carbon Reporting Requirements:

- The introduction of mandatory carbon reporting requirements for UK businesses was announced by Deputy Prime Minister Nick Clegg at the Rio+ 20 Summit in the summer of 2012.
- Under the plan, mandatory carbon emissions reporting will be introduced from April 2013 for all companies listed on the London Stock Exchange.
- The regulations will be reviewed in 2015, and may be expanded in 2016 to cover all large companies.
- It is estimated that reporting will encourage companies to save four million tons of CO_2 emissions by 2021.

Regulators may not be aware of the difficulties posed by ageing data management systems. Many of the issues discussed earlier, such as lack of data to support supply chain management, will create challenges for retailers as sustainability and ethical issues become higher profile. Reporting requirements may assume a level of access to data and analysis that is not available using current systems.

ICAEW is a founder member of the Global Accounting Alliance, which represents over 785,000 professional accountants in over 165 countries worldwide, to promote quality services, share information and collaborate on important international issues.

ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

Because of us, people can do business with confidence.

ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

T +44 (0)20 7920 8493
E tdaf@icaew.com
icaew.com/auditinsights

linkedin.com – find ICAEW
twitter.com/icaew
facebook.com/icaew