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ICAEW AUDIT & ASSURANCE FACULTY

AUDIT INSIGHTS
RETAIL 2014

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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.

AUDIT INSIGHTS

RETAIL 2014

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.

Audit Insights: Retail 2014 has been drafted by a group of audit experts from the six largest audit firms based on their many years' combined experience auditing retail businesses 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 based on the flags carefully chosen in the first *Audit Insights: Retail*, published in January 2013, which mark 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 auditors and affect every retail stakeholder.

EXECUTIVE SUMMARY: UNDERSTANDING AND REPRESENTING RETAIL BUSINESSES

The retail sector is a significant component of any national economy. In the UK, for example, 9% of all VAT-registered businesses are retailers and retail sales were over £311bn in 2012.[1] This update to the 2013 *Audit Insights: Retail* report raises specific issues and concerns that auditors are aware of in the 2014 retail landscape.

UNDERSTANDING RETAIL BUSINESS CHANGES

- Retailers are changing their business models to adapt to a changed landscape, and are challenged by the fact that sales and returns arise across a number of different channels. There is increasing ambiguity around the source of revenue generation, and this has implications for staff incentives, landlord and franchise negotiations, investment decisions, and reporting to shareholders.
- The common lack of investment in IT and data management identified in 2013 may make it difficult for retailers to access the most relevant sales data to support decision-making. The most successful retailers are those with access to real-time, relevant data, but the majority are still attempting to tackle the challenge of multi-dimensional reporting that their changing business models bring.
- Ambiguity around revenue generation and a lack of investment in IT together contribute to a particular challenge when retailers seek to understand whether an investment made in any given segment of the business is recoverable. Reduced cash flows could mean a charge for impairment in the financial statements.

TRUST, TRANSPARENCY AND REPORTING

- Transparency of information, in the form of clarity and consistency in results and reports, is increasingly in demand both from regulators and from markets.
- In order to maintain trust in their reporting, and certainly before signing off a statement that the annual report is 'fair, balanced, and understandable', retailers should consider: is the story told by my key performance indicators the same as the story told by narrative disclosures, and are both consistent with the results and trends emerging from the financial statements?
- The key performance indicators used in the retail sector remain problematic. No action has yet been taken to challenge the weight given to like-for-like sales figures, to improve their consistency, or to provide contextual information about profitability. In addition, retailers will need to consider what the most appropriate KPIs will be in the new omni-channel world.
- The British Retail Consortium, or some other appropriate industry body, could work with retailers to develop standard methods of calculation for a range of retail key performance indicators, including like-for-like sales figures.

1 Data taken from the British Retail Consortium's 'Retail stats and facts'. See http://www.brc.org.uk/brc_press_zone.asp?iCat=277&sCat=Retail+Stats+And+Facts.

ALL CHANGE PLEASE: THE REVOLUTION CONTINUES

As discussed in the 2013 *Audit Insights: Retail* report, the retail sector is currently reassessing how to engage, interact and transact with customers. This, for many, involves moving from a business model that uses one or two retail channels to the omni-channel approach that the 2013 report described as ‘a revolution in retail’. The trend towards doing business online is almost universal, but specific expressions of that trend are unique to different retailers and products. Customers are embracing change at a rapid rate and the pace of technological changes is also daunting (eg, mobile and tablet use and responses, social media channels going transnational, online marketplaces). Recent developments, such as click-and-collect, have been embedded very quickly and other innovations are gathering speed.

All three of the flags raised in the 2013 *Audit Insights: Retail* report remain relevant in 2014. Retailers are still face the challenge of getting the right balance between online business and bricks and mortar. The difficulties and opportunities associated with a lack of investment in data systems are still vital, as are those associated with restructuring retailers’ property portfolios.

IMPACTS OF CHANGE

The impact of the ongoing changes will affect different stakeholders in different ways, some positive and some negative. Those whose performance is assessed on sales made in a bricks-and-mortar shop might prefer not to see those sales moving online, however if the business maintains profitability an investor will be less concerned. Local authorities are affected by the impact on rates, and this perspective will be different from that of HMRC which levies taxes on the profits of the business as a whole.

Customers may be simultaneously distressed at the societal impact of changes in the high street, and glad to be able to shop online at 2am. For those buying online, the delivery experience forms a key part of their interaction with the retailer. Retailers with the logistics in place to ensure a good delivery and returns experience are more likely to keep their customers’ loyalty.

This report focuses on the impact of change on the largest businesses in the retail sector. The themes, however, affect all retailers, even if the implications and responses vary with size.

NEW DEVELOPMENTS UNDER THREE EXISTING FLAGS

This report seeks to update rather than to replace the 2013 *Audit Insights: Retail* report. The implications of the three flags raised in January 2013 are explored here under two new headings, leading to new challenges and recommendations. A brief update against the points made in the 2013 executive summary is included at the end of this report.

UNDERSTANDING A CHANGING RETAIL BUSINESS

CHANGING AND EXPLAINING THE BUSINESS MODEL

As retailers connect with customers using all the available channels, they are making changes to the traditional retail business model. Auditors have found that all of the boards of their retail clients are discussing the 'clicks versus bricks' question: it is clear that online sales ('clicks') are influenced by the high street presence ('bricks') and vice versa, but how can that influence be understood, managed, and reflected in how they communicate with investors?

Retail boards make decisions that depend on understanding not just the omni-channel environment but also the business itself, its unique circumstances and purpose.

Retailers need to know where the value in their business is coming from. They require both good internal information systems and good analysis to form an understanding of activity across the business. There will never be a one-size-fits-all answer, given the variations between retailers and the constantly changing attitudes of customers.

ATTRIBUTING ACTIVITY ACROSS THE BUSINESS

Operating an omni-channel business model is made more complicated by the challenge of establishing which channel drove a buying decision. Did an online customer visit the website because they saw a store on their way home from work? Did they browse the shelves first before ordering online? Did a customer in a store find the item online first but decide to pop in and get it themselves rather than waiting for delivery? Did a customer order online because their size was unavailable in store?

Once a retailer has decided to link online sales to those made in stores there are a number of ways of doing so. Sales could be connected to stores geographically, based on the delivery location given by the customer buying online. 'Click-and-collect' or 'dispatch from store' arrangements could be used to allocate sales. Returns will also need to be allocated on a consistent basis: if a customer orders online in one area, and returns the item to a store in a different location, where should that activity be recognised?

A revenue recognition decision has accounting and reporting implications. Both for this reason, and to support a real-time response to a rapidly changing world, retailers will need to collect sufficient evidence to support their decision.

UNDERSTANDING A CHANGING RETAIL BUSINESS

CONTINUED

IMPLICATIONS OF REVENUE ALLOCATION

A wide range of decisions in a retail business will be affected by the understanding of where revenue is generated.

Assessing return on investment and making investment decisions. Decisions about how to balance investment online and in stores will be influenced by the perception of how revenues are generated and which assets they can be attributed to. The current pressures on the retail sector increase the decision-making stakes.

Calculating incentives such as bonuses for staff. If staff incentives are based on sales made or revenue earned at individual stores, then bringing online sales and returns into the mix will impact on how closely bonuses reflect business activity.

Negotiating rent agreements with landlords. The 2013 *Audit Insights: Retail* report discussed in detail the challenges that retailers currently face in rationalising their property portfolios. The changing nature of the retail market means that some retailers are looking to close stores but are waiting for leases to expire. Terms used in contracts written before the retail revolution often need clarifying now that 'sales' can mean different things in different contexts. Landlords are also changing their behaviour, and are increasingly open to arrangements such as rent based on revenue at a given store.

Negotiating franchise agreements. Some large retailers have a substantial portfolio of franchise agreements, with arrangements in place to allow franchisees to operate under the retailer's brand. These agreements often include an element based on revenue directly attributable to a store. Clarity and consistency on revenue generation will help to inform negotiations between retailers and their franchisees.

Understanding whether investments made in different parts of the business are recoverable. Any sign of reduced or reducing cash flows in a section of the business could mean that the investment made in that area will not be recoverable. Deciding how to segment the business for investment purposes is a key part of building a business model. The segmentation used for accounting purposes (ie, the identification of 'cash-generating units') and the impact of changes in cash flows on the value of each segment (ie, the impairment of cash-generating units) have increasingly been a topic of discussion between auditors and retailers. This and other implications for auditors are discussed in the article 'Audit Insights: recommendations for retail auditors', which complements this report.

THE INTERNET AND INTELLIGENCE-LED RETAILING

Twenty years ago airlines and hotels were beginning to make sales online, directly to the customer. This change allowed businesses to record details about transactions with customers, to collect those details in vast quantities, and to perform sophisticated analysis that helped shape business decisions across these sectors.

Most retailers are not yet taking advantage of the opportunity to understand their customers better. The exceptions are often companies for whom online retail is at the heart of their business model. Information gathering and analysis allows these retailers to continually refine the offering for their customers, and this capacity is based on investment in the information infrastructure of the business.

INTELLIGENT INVESTMENT

Retailers need to ask whether their management information has kept up with the changing nature of the business, and whether it is able to inform their choices about the business model. The 2013 *Audit Insights: Retail* report identified a surprising lack of investment in management information systems compared to the situation in other sectors. Good data allows a retailer to make better business decisions, and to enhance their proposition for customers. Those who are reticent about investing in information systems should consider what the opportunity cost will be of not having the information available to support growth.

Some retailers have already developed sophisticated monitoring of their customers' shopping habits, using tools such as store cards and loyalty schemes. Most, however, are in the position that airlines, hotels, and car rental companies were in 20 years ago. The systems to collect a vast amount of customer data are not yet present for the majority of retailers, and there are a limited number of in-house analysts to maximise the benefits of the data that is collected. The increase in online activity has created an opportunity for retailers to invest in the same sophisticated data use that airlines, for example, have developed.

There is a need for high quality business intelligence to show where sales are coming from. Understanding the return on investment made in different parts of the business could give a retailer a vital advantage over their competitors. To take advantage of this opportunity, retailers are still grappling with the need to have the technology to accurately collect, store, and analyse data, and have the ability both to change responses to match consumer behaviour and to personalise the response.

A NUMBER OF ACTIONS COULD HELP RETAILERS UNDERSTAND THEIR BUSINESS BETTER AS THE BUSINESS MODEL CHANGES

Questions for retailers to ask themselves

- How satisfied am I that we can accurately attribute revenue generation across the business and that the rationale for this is consistent and evidence-based? In attributing revenue generation, have I considered the impact on:

  – staff incentives?
  – rent negotiations?
  – franchise agreements?
  – investment returns?
  – asset recoverability?
  – future investment decisions?
  – the business model as a whole?

- Am I satisfied that the management information I rely upon provides the evidence I need to make sound decisions, and to shape the changing business model?

- Am I satisfied that I have invested enough in IT systems and analysis to benefit from a better understanding of customer behaviour?

TRUST, TRANSPARENCY AND REPORTING

The current trend towards increased transparency in reporting affects all businesses, but there are specific concerns that retailers will need to address. The requirement for greater transparency may come from regulators, as seen recently in the UK Corporate Governance Code, as pressure from investors, or from new initiatives such as Integrated Reporting. The context, however, is a world in which anybody can access information about a retailer online, carry out sophisticated analysis with widely available tools, and share their conclusions instantly with the world via social media.

PRECARIOUS VISIBILITY: RETAILERS AND THEIR AUDIENCE

Retailers, by their nature, are public-facing businesses whose goal is to build up a large customer base. Most people shop, and this simple fact means that most people have a direct interest in the activity of one or more retailers.

The visibility of retailers creates a need for credibility. Stories about the retail industry reach this wide audience quickly and trust, if lost, may not be easy to regain.

The challenge is to make sure that published information about a retail business is consistent from period to period, and that it all contributes to a clear and accurate representation of the underlying business model.

Retailers who are prepared to communicate with clarity and consistency will be positioned to benefit from greater transparency. After all, a retail business does not generally give rise to particularly complicated annual reports and accounts. There is no reason why they should not be transparent and understandable.

During 2013 many conversations have taken place between large UK retailers and their auditors on whether the annual report is 'fair, balanced, and understandable'.[2] This is an area for judgement. It would clearly be wrong for any business to publish an upbeat annual report which implied great success if the financial statements showed a business struggling on the verge of collapse. For most retailers, and most retail auditors, the situation will not be so clear cut.

Retail boards subject to the 'fair, balanced, and understandable' requirement need to satisfy themselves that the statement they make is justified. Retailers not subject to the requirement would still do well to consider the same issues, in preparation for scrutiny from regulators and others in the future. Auditors working with retailers of all sizes, even though they do not form an opinion on 'fair, balanced, and understandable', can add value by engaging their clients in this area.

2 The UK Corporate Governance code has recently been updated to require the boards of listed entities to include a statement to this effect in their annual report.

QUESTIONS FOR RETAILERS TO CONSIDER

- Is the picture of the business given in the annual report consistent with the results disclosed in the financial statements?
- How does the annual report compare to other publications such as the sustainability report, press releases, and investor briefings? Is there a consistent story? As retailers are increasingly omni-channel operators, connecting with their customers in many different ways, are all of these channels appropriately represented in the business model presented to shareholders?
- How have board members satisfied themselves that they know what their supply chain looks like? The 2013 *Audit Insights: Retail* report raised concerns about the impact of gaps in retailers' IT and data management on their ability to monitor global supply chains. If information about suppliers is included in the annual report, how has the board made sure that it will stand up to scrutiny?
- How have board members satisfied themselves that the key performance indicators disclosed in the annual report and elsewhere are telling the same story as the rest of the annual report and accounts? Are board members satisfied that like-for-like sales, for example, have been calculated on a consistent basis year on year or across the store portfolio? And are board members satisfied that the key performance indicators used are consistent with the strategy of the group?

- Are board members satisfied that they have gained sufficient assurance over the information presented in the annual report? Despite the interest of auditors in consistency and best practice, these disclosures are not covered by the audit in the same way as the financial statements. The board may have gained assurance in the form of internal audit reports, confidence based on controls, or assurance reports obtained from an external provider. An associated question is whether this assurance could or should be shared with readers of the annual report and accounts.

THE KEY PERFORMANCE INDICATOR CHALLENGE

The most difficult reporting challenge for retailers at present is likely to be their key performance indicators. These numbers, many not directly derived from the financial statements, add weight to the narrative of the annual report and are often headline figures for press releases.

Like-for-like sales figures remain the most prominent key performance indicator in the retail sector and are still not prepared on a consistent basis. The 2013 *Audit Insights: Retail* report discusses this issue in detail and suggests that a consistent basis for calculating like-for-like sales figures could be agreed. Because this indicator is calculated on the basis of the value of sales made rather than on the profit margin earned, retailers that are on the verge of bankruptcy may still be able to disclose excellent like-for-like sales figures despite making a loss with each sale. The lack of consistency may also cause difficulties for successful retailers, if they attempt to answer questions such as 'who won Christmas?' No action has yet been taken to move towards consistency, to provide information on profitability, or to challenge the primacy of like-for-like sales figures in the reporting of retailers' results.

TRUST, TRANSPARENCY AND REPORTING

CONTINUED

As the retail business model changes, key performance indicators used in the past may no longer give a balanced picture of the business. As shareholders come to expect greater transparency, choosing and calculating indicators to reflect the most positive story about the business may lead to questions. Retailers will need to continually assess the range of indicators used, and to consider whether they are consistent from one year to the next.

Explanations of the business model and difficult judgements about where sales, returns and revenue arise will affect many key performance indicators. If the business model used by the board no longer considers a store in isolation, but allocates certain elements of online sales to physical stores, then transparency will require the same allocation to support key performance indicators such as sales density and returns.

A NUMBER OF ACTIONS COULD CREATE TRANSPARENCY AND HELP MAINTAIN TRUST IN RETAILERS' REPORTING

Questions for retailers to ask themselves

- Is the story told by my key performance indicators the same as the story told by narrative disclosures, and are both consistent with the story emerging from the financial statements?
- Do my shareholders have the information they need to understand the business model? Am I confident that further transparency or future revelations will not undermine trust in my reporting?
- Can I put my like-for-like sales figures in context? This would mean making sure the calculation method is consistent from one year to the next; disclosing some of the assumptions used in the calculation; and accompanying the disclosure with other indicators of profitability.
- When choosing the range of key performance indicators to make public, have I considered the impact on reporting over more than one year? Do I expect to include the same indicators in next year's annual report and accounts as well?

General recommendations

- The British Retail Consortium, or some other appropriate industry body, could work with retailers to develop a standard method of calculation for a range of retail-specific key performance indicators, including like-for-like sales figures.
- Shareholders, investors, journalists, and other users of the headline like-for-like sales figures announced in retailers' press releases could challenge retailers to relate sales to profitability. They could also challenge retailers on consistency, for example asking whether the 2014 like-for-like sales figures have been calculated on the same basis as the 2013 figures.

AN UPDATE ON THE 2013 RETAIL FLAGS

When *Audit Insights: Retail* was published in January 2013, auditors raised three flags to indicate areas of potential concern in the sector. All three of these flags, summarised below, remain relevant to the current retail market.

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.	As discussed under the first heading in this report, a lack of investment in IT systems continues to pose challenges for retailers and their auditors. We have seen some businesses make the choice to invest in systems, even in times of uncertainty, but most retailers have not done so. This has ongoing implications for shaping and understanding the business model.
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.	The Distressed Town Centre Property Taskforce reported, on 29 November 2013, that the move to online shopping has left most towns with too many shops. Not all retailers would agree with that assessment. Some are looking to expand their store portfolio. Overall, however, the continuing changes are still bringing the same issues, such as dilapidation clauses and onerous lease provisions, into discussions between retail auditors and their clients.
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.	Transparency, key performance indicators and ethical behaviour continue to be areas of concern in the retail sector. The ongoing problem of over-emphasis on like-for-like sales figures, and the increasing pressure for transparency in reporting, are discussed in detail under the second heading in this report.