ICAEW AUDIT & ASSURANCE FACULTY

Audit insights: retail

Like-for-like sales is not the only story

Introduction

This publication is designed to raise awareness of some of the critical areas impacting on retailers' profit margins either currently or in the future.

- For boards and audit committees, a better understanding of why these areas need to be considered when assessing risks. This will also feed into their work on producing a longer term viability statement for the annual report.
- For investors and analysts, to consider other indicators that are important to the underlying value of a business.
- For auditors, some of the key risks that need to looked at when performing audits.
- For the media and public, like-for-like sales are not the only key measures of performance and value.

Profit margins have never been tighter

The retailers who win Black Friday and Christmas are not necessarily those who have made the most like-for-like sales, but those who have made the most money. The most important information – which is sometimes overlooked – is how profitable is the like-for-like sales growth.

Profit margins are a stronger indicator of the financial health of a retailer – all company costs including salaries, fulfilment and logistics, IT infrastructure, property and other operating costs need to be covered – and the data linked to them needs to be transparent and considered carefully.

Retailers are finding themselves squeezed between changes in consumer behaviour and expectations – such as greater demand for value and a stronger fight for the consumer pound, rising required investment in infrastructure, overall cost pressure and volatility in commodity prices, all of which are impacting on profit margins. In this publication we focus on three key areas that stakeholders need to consider to gain clarity and understanding on how well retailers are making profits: changing business models, the impact of the living wage and foreign exchange. While there are many factors that impact on margins, these three are where we anticipate there will be the greatest change and therefore challenge in determining the real performance and value of a retailer.

Changing business models

CHANGING BUSINESS MODELS

Traditional business models based around physical, bricks and mortar shops are evolving. Increasingly retailers are moving to omni-channel operations – their sales channels now include in-store, e-commerce, m-commerce (mobile), and other forms of selling and order fulfilment. Online retailers are seeking a physical presence to showcase their goods and increase sales. Fulfilment remains an operational cost challenge.

WHY IS IT IMPORTANT?

The changing ways that consumers shop mean that retailers are having to re-assess their property portfolio. Some are reducing their bricks and mortar presence to fewer sites – particularly as long lease agreements come to an end. Other retailers are changing the ways in which they use their existing space to enable new services and new formats. Some are now sharing their sites with other retailers, or partnering with them on a combined customer offering.

Retailers are re-engineering their businesses to create single, unified commerce platforms that offer the consumer a seamless, integrated and flexible shopping experience for browsing, purchasing and delivery. eWallet and mobile payment applications are enabling customers to use their smartphones to pay and collect points simultaneously.

In-store and digital assets now have a shorter life span as technology is replaced at a faster rate in response to consumer behaviour and the demands for a personal shopping experience.

QUESTIONS TO ASK

What are the investment costs in infrastructure to deal with increased peaks in store and online demand and to take advantage of new ways of shopping such as ‘click and collect’?

What are the costs of replacing in-store and digital technology to keep pace with changing shopping experiences and consumer habits?

How are retailers treating store impairments? Are any online revenues allocated to the stores, and is there a genuine commercial rationale for this with sufficient reliable evidence? Are these being taken through underlying profits or treated as exceptional items?

The living wage

THE LIVING WAGE

This is top of the agenda for retailers because of the significant impact it will have on cost. Some retailers are already preparing for the introduction of the national living wage initiative. The first increase will come into force in April 2016 when workers aged 25 and over will receive £7.20 per hour.

To illustrate the increase in costs facing retailers, in its first operational year, staff will receive a 10.8% wage rise compared with staff on the 2015 national minimum wage of £6.50 per hour. By 2020 this will have risen to 38.5% compared to the 2015 minimum wage.

WHY IS IT IMPORTANT?

Independent analysis has shown that the greatest impact will be on the retail sector where a large number of sub-living wage earners are employed.

All retailers will be obliged to pay the new rates of pay and as labour costs rise retailers will try to pass these on to consumers in the form of higher prices.

In addition to the large cost of compliance, there will be an increasing cost to ensure pay differentials between grades which may be important in motivating and retaining staff.

Retailers will need to achieve a balance between customer service and a minimum staff delivery model.

Companies which outsource cleaning, catering and other facilities services will need to ensure their contractors pay at least the living wage. Where low-paying services are outsourced, the cost of introducing living wages may be shared between contractor and client.

UK-based suppliers which produce goods in the UK will be required to pay the living wage, which may have an impact on supplier costs.

QUESTIONS TO ASK

What is the impact on retailers' staff costs?

What are the extra costs to maintain pay differentials? The benefits package for some employees may change, for example bonuses, commissions or discounts given to staff may increase.

What is the level of productivity and employee turnover rate? Higher retention rates may lead to higher productivity per employee. To what extent will retailers be able to increase productivity to offset the cost of the living wage?

How has the training and development cost changed? Speciality retailers are better placed to benefit as with higher margins they will be able to invest in staff to improve customer service with increased sales likely to provide a return on investment.

What is the impact on supplier costs and cash flows as suppliers try to push the increase in their cost base up the supply chain? Are suppliers demanding more volume commitments and are more commercial income (volume rebates) deals being negotiated?

What is the cost of investment in infrastructure and new technology to reduce headcount? For example, investment in more self-service and self-scanning technology and in warehouse management systems.

What is the impact on store impairment?

Foreign exchange

FOREIGN EXCHANGE

Retailers import goods and materials into the UK. Currency fluctuations have a significant impact on their ability to set prices and safeguard profit margins. As an example, more retailers sourcing their goods from the Far East have been impacted by considerable volatility in foreign exchange rates.

WHY IS IT IMPORTANT?

Retailers sourcing their goods from outside the UK will need to manage their exchange rate risks to secure their revenues and margins.

Exchange rate fluctuations can cause significant variances in the reported figures of net assets as companies translate the value of their foreign assets and liabilities into home currency for their consolidated financial accounts.

The need to balance changes in customer trends with hedging forward contracts can be very challenging in certain retail areas, for example fashion retailing.

For retailers exporting overseas, the risk is that even if their sales forecasting is correct, and they do receive the expected amount of orders, they will build up debtors from abroad. The foreign exchange forward deals that are booked can become problematic if there is little clarity on when they will be paid and what the exchange rate will be at that time.

QUESTIONS TO ASK

How is the retailer managing their currency risk exposure?

How much of a retailer's supply and customer base is exposed to foreign exchange fluctuations?

What is the difference between the budgeted and reported exchange rates? How much of the retailer's forecast expenditure and revenue is being hedged?

What is the retailer's level of flexibility in changing both suppliers and countries of supply? How quickly can they switch supply on and off to meet customer demand?

What are the exchange rate gains/losses that are presented as other income or expense in the profit and loss account?

How has the level of sales been affected by currency fluctuations? For example, the contrast between reported sales v sales at a constant currency. The difference can be significant.

Audit is a public interest activity. Reports from auditors 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 value for a wider audience.

Audit insights: retail, Like-for-like sales is not the only story is the work of a group of audit experts from the six largest audit firms in England and Wales: EY, BDO, Deloitte, Grant Thornton, KPMG and PwC. It is based on their many years' combined experience auditing retail businesses across the UK and internationally, and their current involvement in planning and delivering audits in this sector.

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