CPAB exchange

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Industry Insights – *Retail*

What is Industry Insights?

This publication is part of CPAB's *Industry Insights* series developed to support audit committees in their oversight of the audit by enhancing the dialogue between the audit committee and auditor.

Industry Insights – Retail discusses certain common areas of focus for an audit of a company operating in the retail industry. These areas may be considered together with the audit committee's knowledge of the industry and the company. An audit approach is a matter of professional judgment influenced by auditing standards, industry risks and specific characteristics of the company.

Common Areas of Audit Focus in the Retail Industry

1. Internal controls including information technology

Point of sale (POS) and inventory systems typically process a high volume of retail transactions, are highly automated and may be integral to a retailer's operations. Due to the high volumes of transactions, data and reports coming from the system are a significant part of management's process in reviewing and reporting on the company's results. Management is responsible for developing and maintaining the company's system of internal controls including controls over information technology (IT) systems. In most cases, the system of internal controls will include a combination of automated and manual controls.

In respect of some risks, it may not be possible or practicable for the auditor to obtain sufficient appropriate audit evidence without reliance on internal controls. A significant deficiency in the controls in a retailer's IT environment may make it difficult for the auditor to rely on certain controls and information and reports created by the system.

Where IT systems are complex, auditors may respond to the risks by involving IT specialists to assist in the assessment of the effectiveness of the IT general controls and the IT environment.

Key processes or controls over sales and inventory may include:

- Controls over the accurate processing of sales in the POS system and the transfer of such information into the general ledger (typically automated controls).
- Reconciliation of sales to cash deposits, and credit and debit card receipts on a daily basis.
- Controls over inventory purchases (typically automated controls with manual reconciliations of unusual or unmatched items).
- Management review of actual financial performance compared to budget or historical results (may include comparable store sales).
- Inventory management at warehouses (typically includes a program of ongoing cycle counts and tracking of movement within warehouses and to the stores).
- Store visits by operations management and internal audit (if applicable) to validate the existence and condition of inventory (typically including cycle counts) and the consistent application of standard operating and control procedures.

2. Supplier / vendor incentives, rebates and discounts

Many retailers receive significant amounts of funds from their suppliers in different forms including incentives, rebates, discounts, and fees for placement of products. This may consist of a large number of individual arrangements where the terms of each agreement can be complex. Interpreting contractual arrangements may involve management making judgments about the extent to which a company has met or will likely meet performance conditions, and estimating the amounts and the period it should be recorded.

An understanding of the terms of agreements with significant suppliers may be essential. If significant incentives, rebates or discounts exist, auditors may find it necessary to review agreements and correspondence with significant suppliers and have discussions with those managing the relationship.

To address risk in this area, the auditor may also send confirmations directly to certain suppliers to verify the terms of the arrangements and amounts owing. Significant differences or continuing areas of disagreement between retailer and supplier may be an area of focus for the auditor.

Where estimating supplier incentives represents a significant risk, the auditor's response may also include obtaining an understanding of and evaluating management's approach to making the estimate, and the reasonableness of the significant inputs and assumptions impacting inventory valuation and the timing of recognition in the income statement. The auditor may also focus on the accuracy of the accruals recorded in the past compared to the amounts received from the various suppliers.

3. Inventory

Verifying the existence, accuracy and valuation of inventory may require the use of professional judgment. The determination of cost and net realizable value may include the allocation of rebates, mark-downs or discounts, the estimation of shrinkage, the estimation of margins (where a retail inventory method is used), and evaluation of the impact of declines in selling prices.

Professional skepticism may be important in assessing the reasonableness of key assumptions. This could include reviewing current and forecast data and challenging the reasonableness of management's inventory and sales forecasting. To do this, an auditor may make inquiries directly with individuals outside of finance and perform look back analyses of a retailer's history in making these estimates.

4. Impairment

The continued recoverability of property and equipment may be a significant area of risk and judgment especially for a retailer with underperforming regions or locations.

Where this represents a significant risk, auditors may respond by involving valuation specialists to assist in the assessment of management's estimated recoverable amount. Professional skepticism may be necessary to appropriately challenge key assumptions including the determination and aggregation of cash generating units, future cash flows, discount rates and the allocation of corporate assets.

Questions for Audit Committees

Depending on the risks and materiality in the particular business, audit committees may choose to discuss the following questions with their auditor.

Internal controls including information technology

1. Did you identify significant deficiencies in the design or implementation of key controls that were relevant to the audit? How were these addressed?

2. What specific issues were noted, if any, in your review of our IT systems that were relevant to the audit? What impact did these issues have on your audit plan? Did you identify any other areas of IT risk and how did you address those risks through your audit?

Supplier / vendor incentives

1. How did you obtain an understanding of the terms of our arrangements with significant suppliers? Did you identify any unusual terms or side agreements in your review?

2. Did you identify any areas where there were disputes with significant vendors or any terms or agreements that may not have been approved? Did you find it necessary to correspond directly with our suppliers to confirm significant terms and the volume of purchases or rebates? If so, what were the results of these confirmations?

Inventory and impairment

1. Can you provide examples of how you exercised professional scepticism (i.e. challenged management on key assumptions, evaluated all facts including contradictory information, obtained additional support for management's representations) in your audit?
   - In considering the net realizable value of inventory, how did you evaluate management's ability to forecast future demand of key inventory items and forecasts of future pricing?
   - If the retail inventory method was used to value inventory, how did you evaluate and challenge the margins used by management to estimate inventory costs?
   - When evaluating the forecasted results used to evaluate for potential impairment, what steps did you take to ensure the reasonability, especially for under- performing locations?

2. Are there any specific locations or regions that you believe are at risk of current or future impairment?

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