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Canadian grocers need to shed more light on supplier payments

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A retailer's deals with its vendors can have a big impact on consumers. The news this week of the Competition Bureau's probe into Loblaw Cos. Ltd.'s supplier relations, and the potential effect on prices, is a reminder of that.

Less known, however, is how "vendor allowances," as supplier payments are called, can boost profits at Canadian grocers. The companies' own lack of disclosure helps create that mystery – and serves to obscure the risks to their shareholders.
Tesco has cut its profit forecast for the third time this year, sending shares down 12%, after finding a fault in its accounts. As Sonia Legg reports, it's the latest blow to the reputation of Britain's biggest grocer.

For more, we turn to the analysts at ***Veritas Investment Research***, who took a peek into the practices after British retailer Tesco PLC said it had overstated its profit guidance by £250-million ($445-million), thanks to issues with its vendor allowances.

What are these "allowances"? They are payments, rebates, credits, cost reductions, or any similar thing that benefits a retailer in a deal with a vendor. Examples include rebates for selling a certain volume of products; compensation for creating dedicated in-store selling displays or payments for preferred placement; or "margin protection" if items show up cheaper at a competitor. This money flows right to retailers' profits as a reduction in their cost of goods sold, which boosts gross, operating and net profits.

Does it really amount to all that much? Well, yes. The Canadian grocers don't provide any numbers, but the two big U.S. chains do. ***Veritas*** analyst ***Kathleen Wong*** rooted through the filings of Kroger Co. and Safeway Inc. and found that vendor allowances represented 8 per cent to 10 per cent of the cost of goods sold in every year from 2007 to 2013, for an average of 9 per cent.

Grocery retailing is a notoriously low-margin business, so when ***Ms. Wong*** applied the raw-dollar amount of allowances to the company's profits, the numbers get bigger. Safeway's allowances ranged from 80 per cent to 120 per cent of EBITDA, or earnings before interest, taxes, depreciation and amortization. Kroger, which is even leaner, saw allowances average 146 per cent of EBITDA over the seven years, with the figure never once below 100 per cent.

The story would be, at best, not much different here. ***Ms. Wong*** was able to use Safeway's restated financials, revised after it sold Canada Safeway to Sobeys last year, to estimate that Canada Safeway's vendor allowances were 12.5 per cent of its cost of goods sold in 2012.

Ms. Wong suspects Safeway's U.S. scale, higher gross profits at Safeway Canada, and exchange rate movements play a large role in the higher number, so she applies the number from Kroger and Safeway's overall operations in examining the Canadian question. The result? Assuming vendor allowances at 9 per cent of cost of goods sold, they would represent 112 per cent, 119 per cent and 101 per cent of the 2013 EBITDA at Loblaw, Empire Co.-owned Sobeys Inc., and Metro Inc., respectively. This means investors in the retailers are at risk of seeing a big chunk of profits wiped out if there's a problem with the vendor accounting.

Let's go back to Tesco, which is the latest retailer to run into serious trouble with its allowances. ***Ms. Wong*** is able to list eight major companies, such as Kmart, Saks and Royal Ahold, charged since 2002 with accounting fraud by the U.S. Securities and Exchange Commission for improper accounting for vendor allowances.

Vendor-allowance accounting also involves a great deal of estimation, creating the potential for error. (Tesco had previously said that it, and its external auditor, believed its accounting controls over allowances were strong.) For example, rebates are booked quarterly but are often based on annual purchasing volume. So, if annual purchases fall short in the final quarter, the company has incorrectly lowered its costs in the preceding three quarters.

Ms. Wong says her analysis suggests the big three Canadian grocers have "material exposure" to vendor allowances and the risks that accompany them. Her conclusion is that they should disclose the allowance amounts, but management of the grocers, in discussing the issue with her, said "additional disclosure would not be provided for competitive reasons."

A spokesman for Loblaw says the company is "confident that all of our financial disclosure is in keeping with Canadian GAAP and securities regulations," and the Tesco situation made Loblaw review its vendor practices, which "further confirmed that our internal controls, accounting and reporting are appropriate."

The Competition Bureau can continue to investigate whether consumers are losing out with vendor rebates and discounts. I've already come to the conclusion that investors are poorer, thanks to the lack of transparency