Complex supplier arrangements case study

Michael (Mike) Wells prepared this case study to support class discussion designed to foster the development of a cohesive understanding of accounting for variable consideration in the retail sector and as a basis for developing capacity to make the judgements necessary to prepare/audit/regulate/analyse such financial information.

"The [Audit] Committee notes that commercial income was an area of focus for the external auditors based on their assessment of gross risks. It is the Committee's view that whilst commercial income is a significant income for the Group and involves an element of judgement, management operates an appropriate control environment which minimises risks in this area. As a result, the Committee does not consider that this is a significant issue for disclosure in its report."

----*Tesco 2014 Annual Report (2 May 2014)*[1]----

The UK Financial Reporting Council (FRC) announces its investigation in relation to the preparation, approval and audit of the financial statements of Tesco PLC for the financial years ended 25 February 2012, 23 February 2013 and 22 February 2014 and their conduct in relation to the matters reported in the company's interim results for the 26 weeks ended 23 August 2014.

-----*UK FRC (22 December 2014)*[2]-----

"…An attentive investor, I'm embarrassed to report, would have sold Tesco shares earlier. I made a big mistake with this investment by dawdling. … Our after-tax loss from this investment was $444 million, about $^1/_5$ of 1% of Berkshire's net worth."

-----*Warren Buffet (27 February 2015)*[3]-----

The UK FRC announces that in 2015/2016 it will focus on the reporting and the audits of businesses where complex supplier arrangements are prevalent: predominantly food, drinks and consumer goods manufacturers and retailers.

-----*UK FRC (29 May 2015)*[4]-----

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[1] Tesco 2014 Annual Report (see http://www.tescoplc.com/files/pdf/reports/ar14/download_annual_report.pdf)

[2] see https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/Investigation-announced-in-connection-with-the-pre.aspx

[3] 2014 Berkshire Hathaway Shareholder Letter (see http://www.berkshirehathaway.com/letters/2014ltr.pdf)

[4] see https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/May/FRC-publishes-Audit-Quality-Inspections-Annual-Rep.aspx

Background

Before the Tesco debacle, errors in accounting for complex supplier arrangements resulted in a number companies restating their financial statements. For example, in 2010 Carrefour restated its 2009 financial statements.[5]

Complex supplier arrangements take a variety of forms. The UK FRC describes complex supplier arrangements as 'fees, contributions, discounts, multiple offers and volume rebates'.[6] They observe complex supplier arrangements as:

- regular features of supplier contracts in a number of industry sectors, including retail.
- involving amounts that are often significant in aggregate to operating margins and other key metrics.
- requiring significant judgements to be made by companies when estimating period end amounts receivable and payable for both annual and interim reporting.

Complex supplier arrangements often involve variable consideration the quantum of which crystalises only over a number of reporting periods. For example, a supplier 'pays' a retailer graduated volume rebates for achieving particular sales volumes of the supplier's products across multiple reporting periods (covering the reporting period and one or more future reporting periods).

What terms are use for complex supplier arrangements?

In their 2015 Annual Reports companies use different terms for such arrangements. For example, Tesco and Morrisons use 'commercial income', Sainsbury's uses 'supplier incentives, rebates and discounts' and Ahold[7] 'vendor allowances'. This case study uses 'commercial income' because more of the companies covered in this case study use that term.

Nevertheless, Morrisons correctly observes that commercial income is not consistently defined.[8] It defines the commercial income to "comprise marketing contributions from suppliers and volume-based rebates". Unlike some of its competitors, it does not include promotional funding, as these are mechanical deductions from costs, and are triggered as units are sold or purchased with no subjectivity or judgement applied.

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[5] Note 1.4 in Carrefour 2010 Annual Financial Statements at http://www.carrefour.com/sites/default/files/Carrefour_Rapport_Financier_2010_72DPI_RVB_GB.pdf)

[6] see FRC Press Notice 8 December 2014 https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/FRC-urges-clarity-in-the-reporting-of-complex-supp.aspx

[7] For example, see Ahold's 2014 Annual Report https://www.ahold.com/Financial-information/Annual-reports/Annual-Report-2014.htm

[8] see page 19 of Morrisons's 2015 Annual Report http://www.morrisons-corporate.com/ar2015/

Accounting requirements and industry norms

In December 2014 the FRC (UK) observed that:[9]

> "there is no single standard within IFRS which addresses the required accounting or disclosures for these types of commercial arrangements. This, together with an absence of well-known industry norms, underscores the benefits of clear information about the extent to which the results and KPIs of retail and other businesses are reliant on judgements and estimates surrounding their complex supplier arrangements. The FRC observes that IFRS, in addition to providing a clear set of principles on how to develop relevant accounting policies, also includes explicit requirements on disclosure of material judgements and significant uncertainties."

Consequently, the FRC called on Boards of retailers, suppliers and other businesses to provide investors with sufficient information on their accounting policies, judgements and estimates arising from their complex supplier arrangements for investors to be able to evaluate the company's performance and financial position where such amounts are, or could become, material.

Extracts from 2015 annual financial statements

The table below presents selected extracts about commercial income from the accounting policies section and the audit report of selected United Kingdom food retailers' 2015 annual reports.

Table 1: commercial income (extracts from 2015 Annual Reports)

Tesco: accounting policy[10]	*Tesco: key judgements*	*Tesco: area of audit focus*
...the Group has agreements with suppliers whereby volume-related allowances, promotional and marketing allowances and various other fees and discounts are received in connection with the purchase of goods for resale from those suppliers. Most of the income received from suppliers relates to adjustments to a core cost price of a product, and as such is considered part of the purchase price for that product. Sometimes receipt of the income is conditional on the Group performing specified actions or satisfying certain performance conditions associated with the purchase of the product. These include achieving agreed purchases or sales volume targets and providing promotional or marketing materials and activities or promotional product positioning. Whilst there is no standard definition, these amounts receivable from suppliers in connection with the purchase of goods for resale are generally termed commercial income. Commercial income is recognised when earned by the Group, which occurs when all obligations conditional for earning income have been discharged, and the income can be measured reliably based on the terms of the contract. The income is recognised as a credit within cost of sales. Where the income earned relates to inventories which are held by the Group at period ends, the income is included within the cost of those inventories, and recognised in cost of sales upon sale of those inventories. …	Accounting for the amount and timing of recognition of commercial income may require the exercise of judgement. The key estimates and judgements made in the recognition of commercial income are as follows: • **volume-related allowances** relate to amounts receivable by the Group for achieving agreed purchase or sales targets within a set period. Where volume-related allowances span different accounting periods, the amount of income recognised in each period is estimated based on the probability that the Group will meet contractual target volumes based on historical and forecast performance; and • **promotional, marketing and other allowances** cover amounts receivable by the Group to support the promotion, marketing and advertising of specific items including promotional pricing discounts, in-store displays, margin protection and cost reimbursements. There is limited judgement or estimation involved in recognising income for these allowances. The group assesses its performance against the obligations conditional on earning the income, with the income recognised either over time as the obligations are met, or recognised at the point when all obligations are met, dependent on the contractual requirements. Refer to Note 3, Note 15, Note 16 and Note 19 for additional income statement and balance sheet disclosure.	...Tesco has agreements with suppliers whereby discounts and rebates are received retrospectively according to the quantity of goods bought and promotional and marketing activity performed in stores and online. We focused on this area as this income contributes a significant amount to the Group results and also due to the fact that these agreements can include a number of characteristics that require judgement to be applied in determining the appropriate accounting based on the terms of the agreement. There may also be incentives for buyers to manipulate the timing of when commercial income is recognised to meet internal targets. Our audit procedures focused, in particular, on the following judgements: • the period which the agreements cover and hence the correct period for recognition; • the determination of volume achieved and the applicable rebate income earned; and • the appropriate recognition of income related to one off agreements and marketing and promotional activity. This risk was heightened during the period following the Group's announcement on 22 September 2014 relating to the misstatement of commercial income. As a result of this announcement our audit in 2014/15 also considered the impact on prior period financial statements of the issues identified during the current period.

[9] see FRC Press Notice 8 December 2014 https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/FRC-urges-clarity-in-the-reporting-of-complex-supp.aspx

[10] see Tesco 2015 Annual Report http://www.tescoplc.com/files/pdf/reports/ar15/download_annual_report.pdf

Table 1 continued**: commercial income (extracts from 2015 Annual Reports)**

Sainsbury's accounting policy[11]	*Sainsbury's: key judgements*	*Sainsbury's: area of audit focus*
Supplier incentives, rebates and discounts, collectively known as 'supplier income', are recognised within cost of sales on an accruals basis as they are earned for each relevant supplier contract. The accrued value at the reporting date is included in trade receivables or trade payables, depending on the right of offset. The most common types of supplier income, in order of magnitude, which Sainsbury's receives, are: • **Discounts and supplier incentives,** representing the majority of all supplier income, linked to individual unit sales. The incentive is typically based on an agreed sum per item sold on promotion for a period. • **Fixed amounts** agreed with suppliers primarily to support <u>in-store activity</u> including promotions, such as utilising specific space. • **Supplier rebates** are the smallest proportion of supplier income. These are typically agreed on an annual basis, aligned with the financial year and are earned based on pre-agreed targets, mainly linked to sales.	Supplier incentives, rebates and discounts, collectively known as 'supplier income', represent a material deduction to cost of sales and directly affect the Group's reported margin. The supplier arrangements resulting in this supplier income can be <u>complex, with income spanning multiple products over different time periods, and there can be multiple triggers and discounts</u>. The three key types are explained in the cost of sales accounting policy on pages 89 and 90, and the level of judgement and estimation involved is considered below: — **Discounts and incentives** linked to individual unit sales are calculated through a mechanical process with no judgement and estimation involved in recording the income received, which is collected in a timely manner throughout the period. — Arrangements for **fixed amounts** involve a degree of judgement and estimation in ensuring the appropriate cut-off of arrangements for fixed amounts which span period-end. These require judgement to determine when the terms of the arrangement are satisfied and that amounts are recognised in the correct period. — **Supplier rebates**, which are agreed with a supplier on an annual basis, require estimates of the income earned up to the balance sheet date, for each relevant supplier contract. Where agreements span a financial period-end, estimations are required of projected turnover and judgement may also need to be applied to determine the rebate level earned as agreements may involve multiple tiers. In order to minimise any risk arising from estimation, supplier confirmations are obtained to agree the value to be recognised at year-end, prior to it being invoiced. Rebates represent the smallest element of Sainsbury's supplier income and by aligning the agreements to Sainsbury's financial year, where possible the judgements required are minimised.	...While the recognition of the majority of supplier income is mechanical and routine in nature, the amount to be recognised in the income statement for elements of supplier income requires management to apply judgement based on the contractual terms in place with suppliers and estimates of amounts the Group is entitled to where arrangements span the financial year-end. **Discounts and incentives linked to individual unit sales** relate to supplier income earned (and therefore accrued) each time a unit of a product is sold. This income stream involves high volume, lower value arrangements, calculated through a mechanical process, and therefore management considers there to be no judgement in determining the amount that the Group is entitled to. Notwithstanding this, this income is material and we therefore primarily focused on the existence of the supplier deals and the accuracy of the data used in the calculations of amounts due. **Fixed amounts** are agreed with suppliers primarily to support in-store activity, including promotions, such as utilising specific space. These deals vary in length and hence may span a financial year-end. Given the nature of these arrangements, income is recorded at the point of billing, which will typically be when the deal commences. A cut-off process is performed by management at year-end to ensure any income relating to deals that span the balance sheet date is recognised in the correct period. Our focus was therefore on whether the fixed deal income recognised existed, whether it had been recorded at the correct amount and whether income recognised was recorded in the appropriate period. **Supplier rebates** are received from suppliers when pre-agreed targets are achieved. These arrangements are typically negotiated annually. The calculation of elements of this income is mechanical in nature as it will typically involve a percentage discount on all relevant product purchased once predetermined volume targets are reached. Management judgement is required when incentive targets <u>span a financial year-end</u>, as <u>management must estimate and accrue the income earned as at the balance sheet date based on forecast sales over the term of the incentive arrangement.</u> Our focus was therefore on whether the supplier rebate income recognised existed and whether it had been recorded at the correct amount and in the appropriate period.

[11] see Sainsbury's 2015 Annual Report http://www.j-sainsbury.co.uk/media/2475907/sainsburys_ar_2015.pdf

Table 1 continued**: commercial income (extracts from 2015 Annual Reports)**

Morrisons: acc. policy[12]	*Morrisons: key judgements*	*Morrisons: area of audit focus*
Commercial income is recognised as a deduction from cost of sales, based on the expected entitlement that has been earned up to the balance sheet date for each relevant supplier contract. The Group only recognises commercial income where there is documented evidence of an agreement with an individual supplier. The types of commercial income recognised by the Group, and the recognition policies are: • **Marketing and advertising funding** (examples include income in respect of in-store marketing and point of sale, as well as funding for advertising) income is recognised over the period as set out in the specific supplier agreement. Income is invoiced once the performance conditions in the supplier agreement have been achieved. • **Volume-based rebates** (income earned by achieving volume or spend targets set by the supplier for specific products over specific periods) income is recognised through the year based on forecasts for expected sales or purchase volumes, informed by current performance, trends, and the terms of the supplier agreement. Income is invoiced throughout the year in accordance with the specific supplier terms. In order to minimise any risk arising from estimation, supplier confirmations are also obtained to agree the final value to be recognised at year end, prior to it being invoiced. Uncollected commercial income at the balance sheet date is classified within the financial statements as follows: • **Creditors:** A large proportion of the Group's trading terms state that income due from suppliers will be netted against amounts owing to that supplier. Any outstanding invoiced commercial income relating to these suppliers at the balance sheet date will be included within trade payables. • **Debtors:** Where the trading terms described above do not exist, the Group classifies outstanding commercial income within trade debtors. Where commercial income is earned and not invoiced to the supplier at the balance sheet date, this is classified within accrued commercial income. • **Stock:** The carrying value of stock is adjusted to reflect unearned elements of commercial income as the stock has not yet been sold. This income is subsequently recognised in cost of sales when the product has been sold. In order to provide users of the accounts with greater understanding in this area additional income statement and balance sheet disclosure is provided in notes 1.6, 5.2, 5.3 and 5.4 to the financial statements.	Commercial income remains an area of focus for the Audit Committee. Commercial income is inconsistently defined. It is a deduction from the cost of purchase and it is recognised in accordance with signed supplier agreements. Subjectivity and judgement is therefore minimised. This is an area which is currently not directly covered by accounting standards and there is no prescriptive disclosure best practice. The Financial Reporting Council (FRC) recently urged the Boards of retailers and suppliers to provide greater clarity in this area. It is important to the Board that the Group takes the initiative and brings clarity and transparency to commercial income and so is providing increased disclosure on controls, on the quantum earned in the income statement and the balance sheet position. Despite most of this income being subject to no or little subjectivity or judgement we have chosen to provide full disclosure – see note 1.6 in the financial statements. Our definition of commercial income includes marketing and advertising funding and volume based rebates. Some commentators include promotional funding in commercial income. We consider such funding as a mechanical deduction from the purchase cost, triggered immediately by Morrisons realising a sale, or a purchase, with no judgement or subjectivity applied. We do not therefore include promotional funding in our definition of commercial income. In addition to disclosing the quantum of commercial income in the income statement, we have also disclosed the quantum of commercial income included in debtors and accrued commercial income at the balance sheet date – see notes 5.3 and 5.4 in the financial statements. By its nature a proportion of commercial income will only become billable to suppliers at or near the reporting period end. However we expect the majority of commercial income outstanding at 1 February 2015 to be collected by the end of the first quarter of the new financial year. In considering the appropriateness of commercial income recognised in the year and the financial position at the year end, the Committee has reviewed in detail reports from management outlining the accounting judgements and the control environment. In reviewing the assumptions made by management, the Audit Committee challenged and understood the key assumptions and judgements including: • Commercial income accrued but not invoiced at half year and year end; and • Recoverability of outstanding invoices. The Audit Committee considered the effectiveness of the operation of key controls as set out below, through review of management's work and that of Internal Audit. The Committee considered the frequency of the operation of controls, the size of samples and challenged management on how controls could be further improved. The controls in operation provide assurance over: • Completeness of supplier agreement documentation; • Accuracy of income recognition in line with agreed policies and the supplier agreements; and • Recoverability of commercial income. Controls in operation for promotional funding and commercial income …	Refer to note 1.1 (Accounting policies), page 75 (Critical accounting estimates and judgements) and notes 1.6, 5.2, 5.3 and 5.4. The Group has two categories of commercial income: marketing and advertising funding and volume based rebates on purchases. Commercial income is recognised as a deduction from cost of sales and is earned over the period of the contractual agreements with individual suppliers, as disclosed in the Group's accounting policy on page 76. The total income recognised in a year is therefore based on the expected entitlement earned up to the balance sheet date under each supplier agreement. The Group separately recognises promotional funding on promotions that are partially funded by suppliers. Promotional funding is an automated deduction from cost of sales, triggered when a sale is recognised. The funding is recognised when the transaction occurs in accordance with the terms of supplier agreements. The amount receivable is wholly based on sales volumes achieved, multiplied by rates agreed with each supplier up-front. We focused on commercial income because of the significance of the amounts to the Group's gross profit, the significant number of transactions and agreements in place with suppliers covering a range of periods and the industry- wide focus on this area of accounting. We focused on promotional funding for the same reasons, although we acknowledge that the level of judgement and subjectivity in the calculations is negligible because of the level of automation. The amount to be recognised in the income statement for commercial income requires management to apply judgement based on the contractual terms in place with each of its suppliers together with estimates of amounts the Group is entitled to where transactions span the financial period-end. The relative level of judgement in each of the categories of commercial income and promotional funding is considered below: **Commercial income − marketing and advertising funding** This income is varied with regards to the nature and timing of the activity to which it relates, and is recognised in accordance with written agreements with suppliers. This income involves a significant number of agreements and its recognition requires limited judgement or estimation by management in determining the amount that the Group is entitled to. Our focus was therefore on assessing whether a written agreement for the marketing and advertising funding existed, whether the relevant marketing or advertising had taken place and whether the income recognised was recorded in the appropriate period. **Commercial income − volume based rebates** Volume based rebates are driven by the Group achieving purchase volume targets set by individual suppliers for specific products over a pre-determined period. There is therefore judgement involved in estimating the volume of purchases, particularly where rebate agreements span a financial period-end. In order to narrow this judgement, management endeavours to structure agreements to coincide with the Group's financial period-end, thereby reducing or eliminating the degree of estimation. In instances where the rebate agreement does not fully coincide with the period-end the key judgement that we focused on was the estimate of commercial income to be accrued at the period-end. **Promotional funding** Promotional funding covers in-store promotions which are partially funded by suppliers. Funding is automatically recognised as goods are sold. The degree of judgement is limited because the amount receivable is wholly based on sales volumes achieved, multiplied by rates agreed with each supplier up-front. Our focus was therefore on whether a written agreement for the promotional funding existed, whether the relevant promotion had taken place, and whether the funding recognised was recorded in the appropriate period.

12 see Morrisons's 2015 Annual Report http://www.morrisons-corporate.com/ar2015/

Materiality

Unlike some of its competitors (for example, Morrisons[13]) Sainsbury's does not disclose the quantum of supplier income within:[14]

- the income statement (as they considered this information to be commercially sensitive); and
- the statement of financial position (as they consider the amounts to be not significant in the context of the balance sheet as a whole and they purport that such disclosure would give no further understanding or comparability to other companies for the reader of the financial statements).

Sainsbury's Audit Committee expanded on the commercial income issues set out in the Directors Report, as follows:[15]

> "In December 2014, the FRC issued a press notice calling on boards of retailers, suppliers and other businesses to provide investors with sufficient information on their accounting policies, judgements and estimates arising from their complex supplier arrangements. The Committee continues to review detailed papers from management on the Group's supplier income policies, accounting and analysis of the quantitative impact, by supplier income type, on the Group's results, including the value and volume of transactions. In light of the guidance, we have included further disclosure on supplier income within our cost of sales accounting policies, judgements and estimates and significant reporting issues considered by the Committee. We are satisfied that the additional disclosures provide users of the accounts with enough clear and relevant information to be able to evaluate the impact supplier income has on the Company's performance and financial position."

In 2014 Tesco admitted to making errors in the accounting for commercial income. However, in its 2015 annual report it judged those prior period errors to be immaterial. Although highlighting the issue as an area of audit focus in the audit of Tesco's 2015 annual financial statements (see below) the auditor (PwC) also judged the commercial income prior period errors to be immaterial.

In October 2015:

- The International Accounting Standards Board (IASB) issued Exposure Draft ED/2015/8 *IFRS Practice Statement: Application of Materiality to Financial Statements.* The objective of the ED is "to assist management in applying the concept of materiality to general purpose financial statements prepared in accordance with International Financial Reporting Standards (IFRS)."[16]
- The FRC (UK) Corporate Reporting Review (CRR) Annual Report 2015 reminded Boards that "an error can be less than a previously calculated quantitative threshold for materiality but still be material in nature when the issue is relevant to investors." The

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[13] For 2014/15, commercial income was £425m (2013/14: £396m) see http://www.morrisons-corporate.com/ar2015/pdf/Morrisons_AR_2014_Full.pdf

[14] see the Strategic Report and the Directors' Report in Sainsbury's 2015 Annual Report http://www.j-sainsbury.co.uk/media/2475907/sainsburys_ar_2015.pdf

[15] see the Audit Committee Report in Sainsbury's 2015 Annual Report http://www.j-sainsbury.co.uk/media/2475907/sainsburys_ar_2015.pdf

[16] see paragraph 1 of ED/2015/8 http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Materiality/Exposure-Draft-October-2015/Documents/ED_IFRSPracticeStatement_OCT2015_WEBSITE.pdf

report goes on to say that if they "were to identify any widespread concerns regarding the application of materiality we would need to consider additional action."[17]

Regarding Complex Supplier Arrangements page 11 of the CRR Annual Report 2015 states:

> "We issued one generic FRC Press Notice during the year, relating to complex supplier arrangements. The issue had gained publicity in the retail sector but it also affected some manufacturing and financial services businesses. The Press Notice explained the importance of users having access to transparent information on the relevant accounting judgements and associated amounts, such as period-end accruals and the effect of changes to estimates on profit.
>
> We have performed an initial review of how FTSE 350 companies responded to our Press Notice. We focused on retailers and their suppliers. Our review found that most companies had responded positively to the Press Notice and the heightened interest in the issue. The most subjective area was the period-end accrual relating to complex or retrospective discounts and rebates.
>
> Whilst we were pleased with the general improvement in disclosures, we would like to see more discussion of how complex supplier arrangements relate to companies' business models and greater transparency regarding the changes in estimates between interim and annual reports. We have written to three retailers where we have identified particular issues relating to their disclosures and will keep the area under review during the interim reporting season.
>
> We remind companies that if there has been a significant change in an estimate made in the second interim period, IAS 34 requires the annual report and accounts to disclose the nature and amount of that change unless a separate second half or fourth quarter report is published."

While, following the press notice in December 2014, the FRC identified improved narrative disclosures about complex supplier arrangements, in October 2015 they found it necessary to remind Boards that they need to discuss the effect of changes in estimates (page 2).

Tesco's commercial income debacle

Tesco PLC is listed on the London Stock Exchange. Consequently, Tesco prepares its financial information in accordance with International Financial Reporting Standards as adopted in the European Union.

On 22 December 2014 the FRC (UK) announced its investigation in relation to the preparation, approval and audit of the financial statements of Tesco PLC for the financial years ended 25 February 2012, 23 February 2013 and 22 February 2014 and their conduct in relation to the matters reported in the company's interim results for the 26 weeks ended 23 August 2014.[18]

Tesco's description of how its Commercial Income Issue unfolded[19]

> In September 2014, information was brought to the Board's attention that indicated that the recognition of UK commercial income was being accelerated and the accrual of costs was being delayed.
> The Board announced on 22 September 2014 that it had identified an overstatement of its expected profit for the half year to 23 August 2014, principally due to this accelerated recognition of commercial income and deferral of costs, in the order of £250 million.

[17] see https://www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2015.pdf

[18] see https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/Investigation-announced-in-connection-with-the-pre.aspx

[19] see http://www.tescoplc.com/files/pdf/reports/ar15/download_annual_report.pdf

The Board decided immediately to appoint Deloitte to carry out an independent investigation of the commercial income numbers in the UK, and to defer the announcement of the interim results to allow time for this. The Deloitte report confirmed that amounts had been pulled forward (in the case of income) or deferred (in the case of costs), contrary to Tesco Group accounting policies; that there had been similar practices in prior reporting periods; and that the current and prior practices appeared to be linked as income pulled forward grew period by period.

In October 2014 as part of the interim results announcement, the Board further announced that the overstated recognition of commercial income was estimated at £263 million. Taking into account the build-up of such overstatement in prior years, the impact on the trading profit expectation for the half year was an over-estimate of £118 million, with overstatement of reported profits in the previous year to 28 February 2014 of £70 million, and in years prior to that of £75 million.

Subsequent to October 2014 we have continued to focus on this area and we have identified some further amounts, bringing the total one-off adjustment relating to prior years to £208 million for our UK and ROI businesses.

Commercial income arises in a number of different ways, including discounts and rebates that suppliers agree to pay us based on the volume of sales achieved and contributions to product promotion expenses. Our external auditors, PricewaterhouseCoopers LLP, focused on this area in their audit of the 2013/14 accounts because of the significance of commercial income, the judgement required in accounting for commercial income including the amounts owed at the year-end, and because of the potential risk of the manipulation of these balances.

The matters surrounding the commercial income issue are now the subject of an investigation by the Serious Fraud Office, and the Company is co-operating fully with this investigation. This has limited the extent of the Company's own investigation and what we can say about the circumstances in which the overstatement occurred. A number of individuals have ceased employment with the Group as a consequence of this investigation.

The "pulling forward" of commercial income from suppliers that was more appropriately attributed to future periods, was clearly a management failure within the UK division. The fact that it remained undiscovered has been a matter of the deepest concern.

The Board had two main priorities in their response to the commercial income issue:

1. Ensure that all available steps are taken to ensure that nothing like this can happen again. The Chief Executive's report details some of those steps. New management is in place, training has been given and the overall commercial relationship with our suppliers and the incentive structure for our commercial teams are being reset.
2. Ensure that the results accounted properly for all commercial income, whether in the UK business or our overseas operations, and with all other aspects of our relationship with our suppliers.

The overarching focus of the Board has been to ensure that this work did not, and does not, distract us from our core business of providing value and a quality service to our customers.

We have noted that the Financial Reporting Council has urged companies to provide greater clarity in respect of their commercial income and the Board has concurred that increased transparency is appropriate. This is discussed in the Financial review, pages 12 to 17.

On 4 February 2015, the Grocery Code Adjudicator ('Adjudicator') announced that an investigation has been launched into the conduct of Tesco under the Groceries Supply Code of Practice. The Adjudicator is specifically investigating Tesco's conduct under provisions of the Code relating to delays in payments to suppliers and payments for shelf positioning. We are continuing to co-operate fully with the Adjudicator's investigation.

2014 Annual Report[20]

The text 'commercial income' is used only six times in the 2014 Annual Report, as follows:

Extract from Corporate Governance Report:

> The Committee notes that commercial income was an area of focus for the external auditors based on their assessment of gross risks. It is the Committee's view that whilst commercial income is a significant income for the Group and involves an element of judgement, management operates an appropriate control environment which minimises risks in this area. As a result, the Committee does not consider that this is a significant issue for disclosure in its report.

Extract from the Independent Auditors' Report to the members of Tesco PLC:

Area of focus	**How the scope of our audit addressed the area of focus**
Recognition of commercial income	
Commercial income (promotional monies, discounts and rebates receivable from suppliers) recognised during the year is material to the income statement and amounts accrued at the year end are judgemental. We focused on this area because of the judgement required in accounting for the commercial income deals and the risk of manipulation of these balances.	We tested the controls management has in place, focusing on controls over price changes and margin reviews. We agreed commercial income recognised to contractual evidence with suppliers, with particular attention to the period in which the income was recorded and the appropriateness of the accrual at the year end. We compared movements year on year in margins for product categories based on an expectation derived from our sample testing of contracts with suppliers.

2015 Annual Report[21]

The text 'commercial income' is used 96 times in Tesco's 2015 Annual Report (2014: 16 fold more instances than in its 2014 Annual Report in which Tesco's Corporate Governance Committee did not consider commercial income to be a significant issue for disclosure). Selected extracts from Tesco 2015 Annual Report relating to Commercial Income are presented below.

Extracts from the Independent auditors' report to the members of Tesco PLC:

Area of focus	**How our audit addressed the area of focus**
Recognition of commercial income	
Refer to page 37 (Audit Committee Report), page 88 (Accounting Policies). Tesco has agreements with suppliers whereby discounts and rebates are received retrospectively according to the quantity of goods bought and promotional and marketing activity performed in stores and online. We focused on this area as this income contributes a significant amount to the Group results and also due to the fact that these agreements can include a number of characteristics that require judgement to be applied in determining the appropriate accounting based on the terms of the agreement. There may also be incentives for buyers to manipulate the timing of when commercial income is recognised to meet internal targets. Our audit procedures focused, in particular, on the following judgements:	As with any significant audit risk, we understood and evaluated the controls that the Group has in place around commercial income. Given the announcement in September 2014 we did not seek to place any significant reliance on the operating effectiveness of the controls and our work in 2014/15 in the UK and around the world principally comprised substantive testing. Our response to this risk included an understanding of the work carried out by Tesco Internal Audit and also the scope and results of the work carried out by Deloitte, who were appointed by the directors to perform an independent review of the commercial income misstatement. In the UK we also used our specialist forensic knowledge to help corroborate the misstatement of commercial income announced by the Group, provide information relating to prior

[20] see http://www.tescoplc.com/files/pdf/reports/ar14/download_annual_report.pdf

[21] see http://www.tescoplc.com/files/pdf/reports/ar15/download_annual_report.pdf

• the period which the agreements cover and hence the correct period for recognition; • the determination of volume achieved and the applicable rebate income earned; and • the appropriate recognition of income related to one off agreements and marketing and promotional activity. This risk was heightened during the period following the Group's announcement on 22 September 2014 relating to the misstatement of commercial income. As a result of this announcement our audit in 2014/15 also considered the impact on prior period financial statements of the issues identified during the current period.	periods and assess the reliability of support provided by management. Our audit approach and results of our work on Commercial Income were discussed on a number of occasions with the Audit Committee. As part of our review of component teams' audit work, the Group engagement team was specifically involved in determining the audit approach in this area in order to be satisfied that sufficient focus was placed on the more judgemental areas. As a result of this involvement we were satisfied that, whilst complex, this area was well understood and there was sufficient focus on this area of risk. Our audit procedures across individual countries included a combination of the following substantive testing, on a sample basis: • detailed testing of commercial income recognised in the period, with particular attention to whether the income was recognised in the correct period and the appropriateness of accrued commercial income at the period end. This involved selecting a sample of amounts invoiced and accrued in the period and agreeing them to supporting documentation and third party evidence. Where available we inspected underlying contractual terms and/or related third party correspondence for a selection of arrangements. We also held a number of discussions with members of Tesco's commercial buying team to understand the nature of individual agreements; • confirming the quantum and nature of a sample of individual commercial income agreements directly with suppliers. Where confirmations were not received from suppliers we examined alternative supporting documentation; • testing that amounts have been recognised in the correct period through examining active promotional deals in-store and online either side of the period end and ensuring that the related income was recognised in the correct period; • testing credit notes issued during the period and post period end to determine whether the income to which they related has been appropriately reversed; • testing supplier statement reconciliations prepared by management for a sample of suppliers; and • inspecting the 'Groceries Supplier Code of Practice' (GSCOP) reporting and any complaints from suppliers. The above audit procedures did not identify any matters that resulted in a significant audit adjustment.
Commercial income – impact on prior periods	
Refer to page 37 (Audit Committee Report), page 88 (Accounting Policies) and page 99 (notes). The Group has stated in its financial statements that commercial income recognised in previous periods was overstated by £53 million in 2013/14 and by £155 million in the periods prior to 2013/14. The directors have concluded that it is not possible to determine the exact amounts relating to prior periods and exactly which periods are affected. Management has however produced a	We challenged and evaluated management's quantitative and qualitative analysis of amounts relating to prior periods and, whilst judgemental, we considered that assessment to be reasonable. The estimated impact on 2013/14 profits was £53 million, which was below our profit based materiality of £150 million that we determined applicable for the 2013/14 audit. The estimated impact on the 22 February 2014 and 23 February 2013 balance sheets was £208 million and £155 million respectively, both of which are less than 0.5% of the Group's

quantitative and qualitative estimate of the amounts relating to prior periods. Having estimated the amounts of potential misstatement relating to prior periods, the directors then assessed whether these amounts are material such that the prior period financial statements would require restatement. The directors concluded that the amounts relating to prior periods, whilst significant, were not, from an accounting perspective, material and consequently that it is not necessary to restate the 2013/14 financial statements.	total assets at each respective period end. The basis on which we considered materiality relating to prior period items is explained further below. After considering carefully the nature and the quantum of the estimated amounts relating to prior periods we concurred with the directors that these amounts, whilst significant, were not material and the prior period financial statements did not require restating. The estimated impact on prior periods has been charged to the income statement in the current period and the Group has separately identified this as a one-off item. We concurred with this accounting treatment and are supportive of the detailed disclosures made in the Annual Report about the impact of the misstatement on the prior periods' financial statements.
Impairment of property, plant and equipment	
Refer to page 37 (Audit Committee Report), page 88 (Accounting Policies) and page 108 (notes). The directors have recorded an impairment charge of £4,292 million against the carrying value of property, plant and equipment across the Group. We focused on this area because the determination of whether or not an impairment charge for property, plant and equipment was necessary involved significant judgements by the directors about the future results of the business and assessment of future plans for the Group's property portfolio in a number of territories. In particular we focused on the reasonableness and impact of key assumptions including: • the cash flow forecasts derived from internal forecasts and the assumptions around the future performance; • the discount rate and the long term growth rate including the assessment of risk factors and growth expectations of the relevant territory; and • the assumptions used in the valuations prepared to support the fair value of certain assets and also the assessment of the external valuers as management's expert.	We evaluated management's impairment calculations in local territories, assessing the future cash flow forecasts used in the models, and the process by which they were drawn up, including comparing them to the latest Board approved budgets, and we tested the mechanics of the underlying calculations. We understood and challenged: • the assumptions used in the Group's five-year Plan and the long term growth rates by comparing them to economic and industry forecasts; • the discount rate by assessing the cost of capital and other inputs and comparable organisations; and • the assumptions used by the external valuers to determine the fair market value of the assets. In performing the above work we utilised our specialist forecasting and valuations knowledge to provide challenge and external market data points to assess the reasonableness of the assumptions used by management. We performed sensitivity analysis around the key drivers of growth rates within the cash flow forecasts to ascertain the extent of change in those assumptions that either individually or collectively would be required for the assets to be further impaired and also considered the likelihood of such a movement in those key assumptions arising. Whilst recognising that cash flow forecasting, impairment modelling and property valuations are all inherently judgemental, we concluded that the assumptions used by management were within an acceptable range of reasonable estimates.
Inventory	
Refer to page 37 (Audit Committee Report), page 88 (Accounting Policies) and page 113 (notes). The Group held inventory of £2,957 million at 28 February 2015. The valuation of inventory was a focus of our audit for the following reasons: • the Group has changed its provisioning methodology for slow moving inventory from an approach based on inventory ageing to one based on forecast inventory usage. The new method of estimating provisions for realisable value requires judgement as it applies provisioning percentages to estimates of future sales. The impact of this 'change in	We examined the basis of the new methodology with respect to slow moving inventory provisions and the appropriateness of the provisioning percentages applicable to individual categories of inventory. We determined that the new methodology of estimating inventory provisions was acceptable. This change in methodology represents a change in estimate and consequently recording the impact in the current period income statement is appropriate. We also agreed that the disclosure of the impact of this change as a 'one-off' cost is appropriate. We examined the changes the Group has made to its assessment of costs directly related to bringing inventory to its final destination (and hence included in the cost of inventory). The new methodology remains compliant with Accounting

estimate' has been charged to the income statement in the current period and, at £323 million, is material; and • the Group has also revised its methodology for including directly attributable overheads within its determination of the cost of inventory. These overheads relate to additional costs incurred through the distribution and in-store processes of bringing inventory to its final destination. This change has involved both a 'change in accounting policy' in respect of the type of overheads included and also a 'change in estimate' of the quantum of costs to include. The directors have determined that the element relating to the type of overheads included, which, as a change in accounting policy would normally be reflected retrospectively in the prior period financial statements, is not material. The directors have therefore recorded the impact of this change in accounting policy (£59 million) in the current period income statement along with the impact of the change in estimate of the quantum of costs to include (£109 million). In addition, given the value of the inventory balance in the UK retail business (£1,637 million) our UK component team identified the existence of inventory to be a particular area of focus for its audit.	Standards. We concurred with the directors that the amounts relating to the changes made to the types of costs which are capitalised in inventory are not material to the Group's financial statements and consequently recording the impact of this change in accounting policy along with the impact of the change in estimate in the current period income statement is acceptable. We also agreed that the disclosure of the impact of these changes as a 'one-off' cost is appropriate. We attended physical inventory counts in all countries within the scope of our audit. In the UK we attended 93 physical inventory counts during the period, performing our own sample counts and checking that the accounting records reflected these physical counts. The counting differences identified, which were immaterial, were adjusted in the accounting records and these differences were at a level consistent with the normal shrinkage provisions held by Tesco UK.
Impairment of investment in associated undertakings …	
Provisions and reserves in Tesco Bank …	
Management override of controls	
Refer to page 37 (Audit Committee Report). As described in the Corporate Governance Report on pages 32 and 33, matters surrounding the commercial income issue are now the subject of an investigation by the Serious Fraud Office (SFO) in the UK. We considered the impact of the override of controls relating to those matters. As explained above we focused on this area and our testing was designed to ensure we appropriately addressed the risk of material misstatement. The challenges faced by the Group this year have caused the directors to examine closely those areas of the financial statements where higher levels of management judgement are required. There is a risk that an undue level of conservatism could have been applied when drawing conclusions from this examination. We considered this risk when auditing judgemental areas, and in our overall review of whether the financial statements presented a true and fair view.	We assessed the overall control environment of the Group, with a particular focus on changes introduced since the Group's announcement in September 2014 relating to the commercial income misstatement. Our procedures included: • understanding the overall governance and oversight process including the independence and objectivity of those charged with governance and the quality and timeliness of the information provided to them. In particular we considered how the oversight process had been impacted by the several recent changes in Board and senior management positions; • consideration of the Group's code of conduct and whistle-blowing processes and the communication of these across the Group. Since the September 2014 announcement, the Board has initiated a Group wide communication programme emphasising the importance of culture, integrity and ethics. We read the associated communications and considered the impact of the programme; • examining the scope and results of the work carried out by Internal Audit. Following the September 2014 announcement, Internal Audit completed its scheduled programme of work to perform a review of the UK commercial income process, and to examine controls around other areas of significant accounting judgement. We took account of the results of this work when planning and performing our audit procedures; and • evaluating the specific changes made to the commercial income processes and controls, and the staff training used to launch these changes. These changes were made mid-way

	through the accounting period and did not operate fully throughout the period. We therefore did not place any significant reliance on these controls as part of our 2014/15 audit of commercial income. We also tested manual journal entries and incorporated an element of unpredictability in the timing of our work and the selection of our samples into our testing plans. We examined the significant accounting estimates and judgements relevant to the financial statements for evidence of bias by the directors that represented a risk of material misstatement. These estimates included the areas of impairment and provisioning as set out in the areas of focus above. As shown by our overall opinion on the financial statements, we were satisfied that the level of conservatism remains within an acceptable range.
Compliance with laws and regulations	
Refer to page 37 (Audit Committee Report). Tesco is currently under investigation by the SFO in the UK following the September 2014 announcement relating to the commercial income misstatement. The outcome of this investigation will not be known for some time. However should fines be levied as a result, these could be material. We focused on this area given the level of judgement required by the directors in assessing whether a provision for future fines is required at this time.	We met with Tesco internal and external legal teams to understand and discuss the status of any legal claims. We read the minutes of Board meetings and the Executive Committee to consider whether the directors are aware of amounts that should be provided for. We read the disclosures made in the Annual Report relating to the SFO investigation. We obtained confirmation from the directors (via the management representation letter) that no provisions are required at this stage.

How we tailored the audit scope

…

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole. In addition, we used our quantitative assessment of materiality when assessing the impact of identified misstatements arising during the period that could have an impact on the current period and/or the prior period.

- where misstatements were identified which related to the current period income statement the quantitative materiality set out in the table below (£50 million) was used to determine whether misstatements should be adjusted. For misstatements that did not impact profits and only affected the balance sheet we did not consider it appropriate to use a standard, profit based measure of materiality and our quantitative assessment had regard to whether the misstatement was above 5% of the balance sheet line to which it related and/or 1% of total assets; and

- where misstatements were identified in the current period which related to financial statements issued in prior periods (for example the commercial income issue described above) we considered the quantitative materiality of these items in two ways – by considering the impact on previously reported profits against the profit based materiality we determined in the previous period (in 2013/14 this was £150 million) and also the impact on the previously reported balance sheet using the balance sheet metrics referred to in the previous bullet.

For all misstatements we also considered whether their nature or other qualitative factors meant that they were material.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Overall Group Materiality	£50 million (2013/14: £150 million).
How we determined it	Professional judgement having applied benchmark percentages to a number of profit measures and considering the overall scale of the business. Overall Group materiality in 2013/14 was £150 million, which represented approximately 5% of profit before tax adjusted for restructuring and one-off items.
Rationale for benchmark applied	Given the significant reduction in the Group's profits compared to the prior period we considered materiality in a number of different ways, including:

	• the methodology we used in the prior period, namely 5% of statutory profit before tax adjusted for restructuring and one-off items. This would have resulted in an indicative overall materiality of £22 million; and • our standard benchmark of 5% applied to a three period average of statutory profit before tax adjusted for restructuring and one-off items. This would have resulted in an indicative overall materiality of £117 million. In our professional judgement, we concluded that the higher end of the range (£117 million) would encompass amounts which, if impacting reported profits, could influence decisions made by the company's members as a body, and which therefore would be considered material. We also concluded, in our professional judgement that amounts at the lower end of the range (£22 million) would not influence such decisions, given the scale of Tesco's operations. We therefore determined that an appropriate level of materiality for performing the 2014/15 audit would be within this range, whilst at neither the upper nor lower ends. Based on our professional judgement, we selected an overall materiality level of £50 million.
We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £2.5 million (2013/14: £7 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons. …	

QUESTIONS FOR CLASS DISCUSSION

1. What are the economics of complex supplier arrangements (sometimes called ‘commercial income’)?
2. If you were thinking of buying shares in the food retail sector, what information would you want about each food retailer’s commercial income?
3. What accounting, if any, does International Financial Reporting Standards specify for commercial income?
4. How should a retailer determine its accounting policy for the main types of commercial income?
5. What judgements must food retailers make in accounting for commercial income that involves variable consideration?
6. Are the disclosures about commercial income in Tesco’s 2014 and 2015 annual financial statements adequate? Explain why or why not.
7. Regarding Sainsbury’s 2015 Annual Report:
    a. Does not disclosing the amount of supplier income in the income statement (because it is judged to be commercial sensitive) contravene the reporting requirements Sainsbury’s is subject to?
    b. Does not disclosing the amount of supplier income in the statement of financial position (because management assesses the amounts to be not significant in the context of the balance sheet as a whole and they purport that such disclosure would give no further understanding or comparability to other companies for the reader of the financial statements) contravene the reporting requirements Sainsbury’s is subject to?
    c. Do you agree with the Audit Committee that enough clear and relevant information is provided to enable users to evaluate the impact supplier income has on the Company’s performance and financial position?
8. From the accounting policy disclosures in Morrisons’s 2015 consolidated annual financial statements, can you ascertain how management makes the judgements to apply its accounting policy for the recognition of commercial income?
9. Are the changes in Tesco’s 2015 financial statements relating to commercial income arising from the regulatory action:
    (i) a change of accounting estimate;
    (ii) a change of accounting policy;
    (iii) a change in classification arising from a change in use;
    (iv) a change in classification arising from a change in circumstances; or
    (v) the correction of a prior period error?
10. In your judgement are the commercial income errors in Tesco’s 2015 annual financial statements (including comparative information) material? Justify your answer, elaborating on the factors you considered in assessing materiality.
11. If you were auditing Morrisons, Tesco and Sainbury’s what questions, if any, would you ask about their accounting for commercial income?

 This material has benefited greatly from the feedback and comments from people attending a series of workshops on the Framework-based approach to teaching general purpose financial information and from peer review by a number of anonymous reviewers.