A Close Inspection of Shoppers' Revenue Accounting

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We interrupt the drumbeat of stories about the new Ontario prescription drug policy to give you even more bad news about Shoppers Drug Mart Corp.: Upcoming accounting rule changes will expose the company's top line as less robust than you might think.

The issue is with the Shoppers Optimum Program that gives customers points for purchases, then lets them redeem those points for free stuff. It's one of the largest loyalty card programs in Canada, and the company cites it as a contributor to its top-line growth.

Canadian Generally Accepted Accounting Principles (GAAP) lack guidance on how to account for sales linked to a loyalty program, however. This has allowed Shoppers to take a revenue-boosting approach, according to analyst ***Kathleen Wong*** at ***Veritas Investment Research Corp***., who published a report earlier this year.

We don't know for sure, since Shoppers does not make a precise disclosure of its accounting method in its financials, and would not co-operate with ***Ms. Wong***, she said. Instead, she developed her understanding of Shoppers' approach from a source outside the company.

Ms. Wong uses the example of a customer who makes $1,500 in purchases at Shoppers and earns points that can be redeemed for $25 in merchandise. ***Ms. Wong*** said Shoppers recognizes the $1,500 in sales when they occur. It then recognizes another $25 in revenue when the points are redeemed, even though the customer isn't handing over any money to pay for the goods. Total sales: $1,525.

That won't be acceptable next year when Shoppers adopts International Financial Reporting Standards. Under IFRS, the company must subtract the reward value earned at the time of the sale. The $1,500 in sales becomes $1,475. The $25 in rewards is then recognized when they're redeemed. Total sales: $1,500.

Shoppers itself hints that its revenue recognition policies differ from IFRS. In its most recent quarterly report, it says the upcoming accounting standard "is based on a view that customers are implicitly paying for the points they receive when they buy goods or services and, therefore, a portion of the revenue should be deferred at the time that points are issued ... (it) will impact the measurement and recognition of the company's Shoppers Optimum loyalty card program."

Company spokeswoman Tammy Smitham declined to respond to questions about the ***Veritas***' critique, saying the company does not make specific comment on analysts' reports. She also added that "we account for the program in accordance with Canadian GAAP."

Veritas' ***Ms. Wong***, who currently rates Shoppers stock a "buy" despite her concerns about its accounting, is quick to note that the company's methods do not affect gross profits or earnings per share. Those numbers would still be the same under IFRS, so earnings-based valuations aren't distorted by Shoppers' current choices.

What is distorted, however, is revenue and, perhaps materially, same-store sales growth (revenue gains at locations open at least one year). ***Ms. Wong*** believes the Optimum program is adding something on the order of 1 to 3 per cent to top-line revenue.

When Shoppers begins to defer the revenue from the points portion of the transaction in 2011, it could take a serious slice off same-store sales growth, which ranged from 4.0 to 5.7 per cent in 2009. Shoppers' same-store sales growth was just 3.1 per cent in the first quarter of 2010, dangerously close to the upper range of ***Ms. Wong's*** estimate.

"We think the same-store sales growth numbers will not look as good as in 2010, because they won't be able to play the inflation game in 2011," she told me in a recent interview.

The IFRS change also removes a tool from Shoppers' quiver in boosting sales in any given quarter. Currently, if the chain runs a promotion and ratchets up the number of points it awards for a sale, it's also boosting current revenue - and further improving comparisons.

Ms. Wong's suspicion is that what Shoppers is doing is not unique, and "it's very possible that other Canadian retailers are using the same method."

What that means for 2011, then, is that at least Shoppers - and perhaps other players in the Canadian retail sector - will report lower same-store sales growth that'll catch investors off guard. Companies caught in the trap will point to new accounting rules as if they had no choice in the matter.

Shoppers, and any other retailer with similar accounting, had a choice all along. They opted for a method that pushed a shiny sales growth figure to the forefront, rather than one that would more accurately portray their real revenue picture.