



Cases in Strategic-Systems Auditing



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KPMG/University of Illinois Business Measurement Case Development and Research Program

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Introduction

Mary Lou, a KPMG assurance partner, looked up from her desk as Laura, a recently promoted senior, entered her office. After exchanging the normal pleasantries, Laura said, “I am scheduled to attend specialized training for retail clients next Monday in London.”

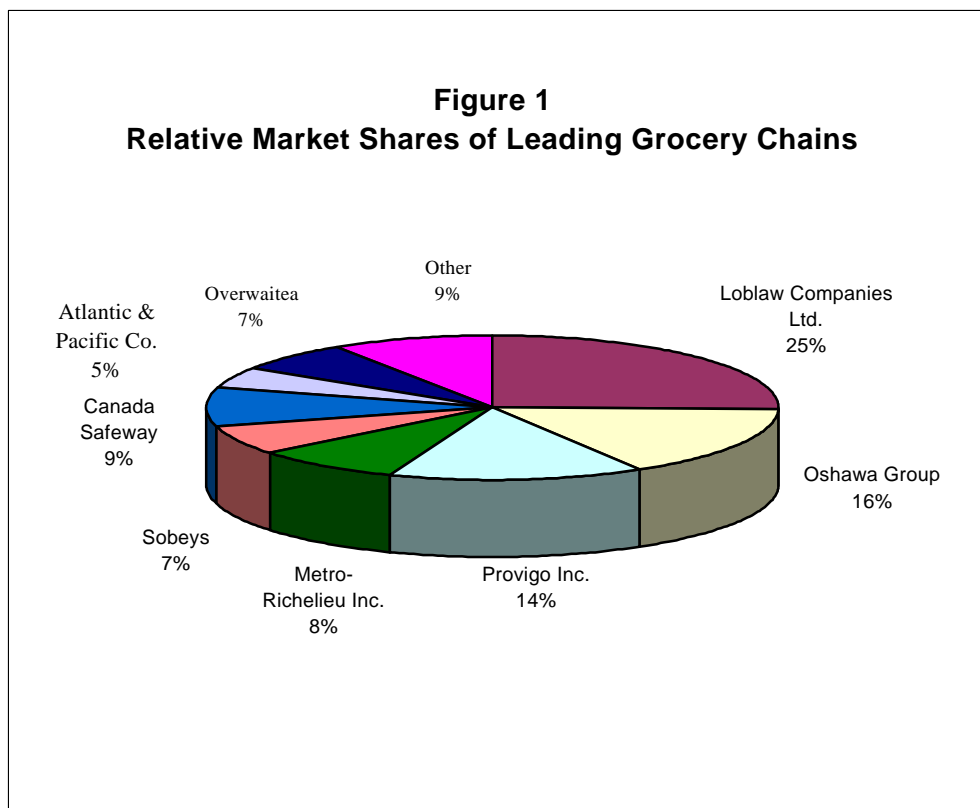
“Yes,” says Mary Lou, “the course will be an excellent vehicle for you to enhance your knowledge of the retail industry. Now that you are assigned to the Loblaw Companies Ltd. engagement that knowledge will be invaluable. As you probably know, Loblaw is the largest food distributor in Canada and one of the largest clients in our office.” Mary Lou continues, “We will view Loblaw’s business in much the same way that management views the company because the focal points of our audit will be strategic risks, process risks, and the financial-statement implications of such risks. Among other matters, you will need to understand business models, strategies, business processes, and controls within the grocery industry in general and for Loblaw specifically. You also will need to know how to measure industry performance and calibrate Loblaw’s performance against industry norms. Obviously, a thorough understanding of retailing in general and food distribution, specifically, will be essential to a successful audit. Enjoy your trip to London and I hope you learn a lot during the course.”

Part I

On her return from London, Laura and the other audit team members prepared the following descriptive analyses of the grocery industry and Loblaw's competitive position in that industry.

Grocery Industry

The grocery industry in Canada is competitive and dominated by eight major chains that hold approximately 75 percent of the traditional food distribution market.¹ Loblaw Companies Ltd., with 1997 sales of (Cdn)² \$11.01 billion and 70,000 employees, is the market leader in Canada (see Figure 1) and the eighth largest in North America.³



Source: Canadian Grocer

The figures are derived by applying revenue statistics from *The Canadian Grocer* to the industry statistics provided by Statistics Canada (see Table 1).

¹ *First Marathon Securities Ltd. Loblaw Companies – Company Report*, July 22, 1997.

² All dollar amounts contained in this case are denominated in Canadian dollars (Cdn). At December 31, 1997, one Canadian dollar was equivalent to .69840 U.S. dollars.

³ *Loblaw Companies Limited 1997 Annual Report* and www.loblaw.com/ABOUTom.htm assessed October 22, 1998.

The industry has shown little growth in recent years (see Table 1) and faces increased competition from nontraditional retailers such as warehouse clubs⁴ (e.g., Costco), drug chains, mass merchandisers (e.g., Wal-Mart), and Internet companies. Furthermore, customers are increasingly moving away from traditional food items in favor of food-away-from-home purchases. In response, grocers are investing heavily in new distribution and logistics technologies in order to lower costs and provide better service. They also are changing the balance of products favoring fresh produce and ready-made meals. Loblaw, the market leader, has been at the industry forefront in introducing several of these changes.

Table 1
Growth in Food Distribution Market (\$Cdn, millions)

	1993		1994		1995		1996		1997	
	\$ 000s	\$ 000s	Percent Change	\$ 000s	Percent Change	\$ 000s	Percent Change	\$ 000s	Percent Change	
Supermarkets and grocery stores	47,690	49,749	4.3 %	49,909	0.3 %	49,264	-1.3 %	52,198	5.9 %	
Other food stores	3,385	3,720	9.9 %	4,153	11.6 %	4,188	0.8 %	4,141	-1.1 %	
Total	51,075	53,469	4.7 %	54,062	1.1 %	53,452	-1.1 %	56,339	5.4 %	

Source: Statistics Canada

⁴ A warehouse club offers products at low cost but solely in large quantities/sizes. They tend to be membership based.

Loblaw

Loblaw holds approximately 20 percent of the market for food sold through conventional food outlets. It has significant presence in all provinces except Quebec (a predominantly French speaking part of Canada), where it has market share of less than 1 percent.⁵ It is the market leader in Ontario (33%) and in Manitoba and Saskatchewan (46% each). It has 18 percent of the Alberta market—behind Safeway (31%)—and 8 percent of the British Columbia (BC) market trailing Overwaitea (31%), Safeway (28%), and the Oshawa Group (11%).⁶ Two thirds of Loblaw sales are from Ontario and the Atlantic Provinces (the four eastern-most provinces) with strong growth in all regions.

Loblaw's *1997 Annual Report* was bullish on the company's accomplishments and future prospects:

Loblaw Companies strives to provide superior returns to its shareholders through a combination of share price appreciation and dividends. To this end, it follows certain fundamental operating principles. It concentrates on food retailing, with the objective of providing consumers with the best in one-stop shopping for everyday household needs. It maintains a significant program of reinvestment in and expansion of its existing markets. It is highly selective in acquisitions and continues to invest in products and technology. Loblaw seeks long term, stable growth, taking managed operating risks from a strong balance sheet position...

...The year 1997 was an outstanding one for Loblaw Companies by any measure. Sales were up 12% from 1996, at \$11.01 billion, with operating income of \$426 million, net earnings of \$213 million and earnings per share of \$.88 all setting new highs.

Earnings per share have tripled (\$.88 from \$.29) in the last five years.

Sales throughout the Canadian business are now increasing rapidly, at the rate of about \$1 billion in 1997, following a \$.7 billion growth in 1996, as stores in existing markets are enlarged and modernised and as we enter new markets. This growth follows a six year period (1990-1995) of flat sales in the West of approximately \$2.9 billion per year, during which time, store and customer rationalizations in wholesale operations were completed.

In fact, sales is the "big story" in Loblaw Companies today. In a total market (food sold through stores of any type) that is growing about 3 percent a year, our Canadian sales have grown by 20 percent in the last 2 years (26 percent in the West and 17 percent in the East). We expect sales to at least match these growth rates in 1998 and 1999...

While the market value of Loblaw Companies has increased by over 150 times [over the last 20+ years], we think its best days are still ahead. *Annual Report 1997*

Industry analysts echoed these sentiments. One analyst regarded Loblaw's position as "increasingly unassailable," while the *Canadian Business Service* rated Loblaw "a buy for long-term growth."⁷

⁵ Subsequent to the events reported in this case, Loblaw acquired Provigo, which has a major presence in Quebec.

⁶ *First Marathon Securities Ltd. Loblaw Companies – Company Report*, July 22, 1997.

⁷ *First Marathon Securities Ltd. Loblaw Companies – Company Report*, July 22, 1997.

Recent financial performance of Loblaw Companies Ltd. is summarized in Table 2.

Table 2
Financial Performance of Leading Canadian Grocery Chains

Company	Net Earnings/ Revenues	Net Earnings/ Equity	Net Earnings/ Assets	Debt/ Equity (Excluding Cash)	Operating Margin/ Revenues
Loblaw Companies Ltd.	1.9¢	14.2	5.3	0.87	5.21
Oshawa Group	0.9¢	6.7	3.7	0.17	2.37
Provigo Inc.	1.4¢	10.3	6.9	1.36	3.83
Metro-Richelieu Inc.	1.9¢	11.2	9.1	0.35	4.50
Empire Co. (Sobeys) Inc. (see note)	1.6¢	11.0	2.9	2.14	5.65
Average	1.5¢	10.7	5.6	0.98	4.31

Sources: *The Globe and Mail*, "Report on Business" (July 1998) and *Financial Post*, "Investment Reports" (May 1998). Data on Canada Safeway, Overwaitea, and A&P are not available because they are nonpublic companies in Canada.

Note: Empire Co. (Sobeys) Inc. data include large real estate and investment holdings in addition to grocery sales. Therefore, certain ratios like debt/equity are not comparable to other industry members.

The current strength of Loblaw Companies contrasts with its position 25 years ago when Galen Weston assumed the chairmanship of the parent company, George Weston Limited (see Box 1). At that time, the company controlled the Loblaw retail chain in Ontario, which was underperforming, and had ownership interests in scattered retail and wholesale companies in Ontario and other provinces. Among Galen Weston's first steps was to hire several exceptionally creative young managers, including Richard J. Currie, who before long was given responsibility for Loblaw Companies Ltd.'s retailing and wholesaling operation in North America. (Currie is now president of Loblaw and George Weston Ltd.)

Currie revitalized the retail and wholesale operations. He had store interiors and exteriors refreshed with bold colors and installed theatrical intensity lighting to highlight products. A rigorous and imaginative corporate identity program made every Loblaw location and product instantly identifiable and set new standards for such programs in North America. Significant emphasis and effort was placed on private brands and for improving the quality of fresh foods. Visually attractive and contemporary promotional

Box 1

Corporate Profile:

George Weston Ltd. <http://www.weston.ca>
at September 29, 1998

George Weston Limited, a broadly based Canadian company founded in 1882, operates in the food processing, food distribution, fisheries and forest products businesses in North America. 1997 sales were \$14 billion Cdn. . . .

George Weston Ltd. operates these diverse businesses through: Weston Food Processing, primarily a fresh and frozen bakery and a dairy and fish processor; Loblaw Companies Limited, the largest food distributor in Canada; and E.B. Eddy, a value-added forest products processor.

George Weston Limited is committed to creating value for its shareholders and to the belief that it should participate along with its more than 83,000 employees throughout its businesses, in supporting the communities in which it operates.

materials and techniques complemented the merchandise and its presentation. The multi-faceted assault on customers' attention worked. Customers flocked to the stores and the Loblaw renaissance was underway.

Current Strategy

Expansion, Upgrading, and Store Attraction

Loblaw continues to pursue market growth and increasing shareholder returns. Central to the company's strategy has been aggressive expansion of new stores and upgrading existing stores.

Significant investments in new store real estate and a continual store update and renewal program together with ensuring the product and service offerings within each of the stores are vast, compelling and provide great value to our customers, have been the cornerstones of growth for the business. (*Annual Report, 1997*)

Loblaw has opened new stores at a rate far exceeding that of its competitors. Over the past seven years it is responsible for 40 percent of the industry's investment in new stores. In 1997 alone, it added 18 percent to its square footage in western Canada and 8 percent in the East.⁸

Similar expansion is planned for the next few years. The changes in 1997 and those planned for 1998 are summarized in Box 2.

Loblaw consistently has invested in refurbishing and upgrading its stores. Improvement in décor and layout has been a high priority since Richard Currie became President. Stores in existing markets are enlarged and modernized regularly. Total investment in new stores and upgrading of existing stores totaled \$517m in 1997, a sum in excess of net earnings.⁹ In determining where to build or relocate stores, management follows careful analysis of demographics and consumer spending patterns. Loblaw assesses national market demand (projected potential sales) for each of its existing and potential sites.

EXPANSION PLANS AT LOBLAW		Box 2
Source: 1997 Annual Report		
<u>1997 Review</u>	<u>1998 Outlook</u>	
<i>Eastern Canada</i>	<i>Eastern Canada</i>	
<ul style="list-style-type: none">• 39 new corporate and franchise stores• 31 stores renovated or enlarged• 8% increase in retail square footage	<ul style="list-style-type: none">• 35 planned openings or major expansions totaling 1.5 m square feet• 25 planned renovations or minor expansions• 7 planned new stores in Montreal, Quebec	
<i>Western Canada</i>	<i>Western Canada</i>	
<ul style="list-style-type: none">• 5 Superstores and 9 conventional stores opened• 7 Wholesale Clubs opened• 18% increase in retail square footage	<ul style="list-style-type: none">• 5 planned openings of The Real Canadian Superstore• 5 planned openings of The Real Canadian Wholesale Club• 12 conventional stores planned	

⁸ Loblaw Companies Limited 1997 Annual Report and First Marathon Securities Ltd. Loblaw Companies – Company Report, July 22, 1997.

⁹ Loblaw Companies Limited 1997 Annual Report Consolidated Cash Flow Statement.

A noticeable trend has been the movement to larger stores. Over the past five years, Loblaw has increased its average store size by 36 percent, that is, from 32,000 to 43,600 sq. ft.¹⁰ In the West, the average store size is over 100,000 square feet. In 1997, sales per square foot improved by 2.9 percent¹¹ compared to the prior year.

Larger stores, in general, are more profitable than smaller stores because of the greater variety of nonfood items that can be offered (e.g., pharmacy, health and beauty care, general merchandise, photo-finishing, dry cleaning, flowers, music, videos, books, printing, postal services, and travel services). Recently, banking services were introduced in some stores through PC Financial (www.preschoice.financial.com) in collaboration with the Canadian Imperial Bank of Commerce, one of the largest banks in Canada. This movement to one-stop shopping is a worldwide trend in the grocery industry.

Responding to Consumer Preferences

Loblaw is alert to market trends. Information on consumer spending patterns and product choices comes from three main sources: product sales data, customers, and vendors. Store managers monitor changing purchasing patterns in their stores and division category managers interpret trends from aggregated sales data.¹² Sales of each item within a category also are monitored. Loblaw is able to track sales and revenue trends and its share of the market for individual items through its subscription to surveys conducted by AC Neilsen. From the retailer's perspective, it is preferable to have national rather than regional brands with fewer vendors. Category management is widely regarded in the industry as a blend of financial analysis, demographic changes, and "gut feel."

Customers are surveyed in a sample of stores, providing satisfaction data on each department. Surveys and focus groups are conducted outside the stores. Each year, vendors approach Loblaw with several thousand new product options, of which a small percentage will be accepted for trial. These offerings represent the suppliers' assessments of market developments. Only a few of those products accepted for trial ultimately are successful with consumers.

Catering to the needs of particular customers is increasing. Within stores, products reflect the needs of groups such as families, the elderly, vegetarians, diabetics, the health conscious, etc. Products are sold in large sizes known as Club PackTM for the bulk buyer, while older customers need smaller packages and larger labels. In recent years, Loblaw has responded to the growing demand for "meal solutions." Thus, food sometimes is grouped less by department, but rather by how it can be combined to make a complete meal.

Given the time pressure on consumers, convenience and speed of service are increasingly important. Loblaw has responded with accessible layouts and improved checkout technology to speed the checkout process. The importance of speed is reflected in the shift from buying ingredients to buying ready-prepared meals. In the United States, 50 percent of consumers' food purchases are from restaurants, fast-food outlets, and ready-to-eat meals. The figure in Canada is 38 percent, and is increasing by about 2 percent per year.¹³ In 1997, supermarkets ranked third (17%) after fast-food outlets (35%) and conventional restaurants (26%) as a source of take-out food. In response, Loblaw is expanding the availability of ready-prepared meals, sales of which

¹⁰ In the West, 100,000 sq. ft. superstores with 35 percent nonfood items are very successful. In Ontario and Atlantic Canada, the emphasis is on stores in the range of 50,000 – 80,000 sq. ft.

¹¹ *Loblaw Companies Limited 1997 Annual Report* p. 6.

¹² The complexity of category management is illustrated by the fact that there are 150 categories within dairy and frozen foods alone. For example, "cheese" is one category in that group.

¹³ *First Marathon Securities Ltd. Loblaw Companies – Company Report*, July 22, 1997.

tripled in 1997 as a percentage of total supermarket industry sales. In addition, Loblaw has introduced restaurants (owned by a third party) into some of its Toronto stores.

Loblaw is a strong competitor because it can respond quickly to consumer spending patterns by aligning store banners and formats to changing neighborhood demographics. The range of banners (shown in Box 3) partly reflects the process of growth through acquisition. Loblaw strategically uses its banners to serve various segments of the market and to target different consumer categories. For example, the “No Frills” banner is a low price, modest-sized option. “Loblaws” is a larger, competitively priced format with a greater range of items in a more up-scale setting. These different banners and formats (i.e., size of store, range of products, and combination of price/service) are used in different neighborhoods. As the neighborhoods change, so do the banners and formats. The ability to switch banners and alter formats is underpinned by the flexibility provided by the long-standing preference within Loblaw for owning, rather than leasing, its real estate sites.

Box 3

Banners of Loblaw Companies Ltd™

<i>Western Canada</i>	<i>Total</i>	<i>Eastern Canada</i>	<i>Total</i>
<u>Retail</u>	<u>Stores</u>	<u>Retail</u>	<u>Stores</u>
The Real Canadian Superstore	40	Loblaws	68
The Real Canadian Wholesale Club	19	Zehrs Markets	38
		Zehrs Food Plus	17
		Atlantic Superstore	18
Extra Foods	68	Atlantic SuperValu	16
		The Super Centre	4
		Atlantic Save	2
		Easy	
		Dominion	16
<u>Wholesale</u>		<u>Wholesale</u>	
Shop Easy Foods	64	No Frills	63
Lucky Dollar Foods	206	Atlantic Save	41
		Easy	
Super Valu	37	Fortinos	18
Extra Foods	15	Independent	41
		Valu-Mart	61

Competitive Pricing

Distribution

The ability to reduce distribution costs is critical in the grocery industry because distribution, shipping, and storage costs can be as high as 20 percent of the value of products.¹⁴ Loblaw has been successful in improving its distribution and warehousing productivity. In the East, productivity has improved for five consecutive years. Distribution flows are now almost double the volume achieved ten years ago using the same warehouse space.

Current projects at Loblaw include “cross docking;” where goods delivered to warehouses are immediately configured into store deliveries and loaded onto store trucks the same day, and “flow-through;” where store orders are pre-configured by suppliers. Loblaw is testing the use of three-temperature trucks to combine shipment of grocery, refrigerated, and frozen items to increase efficiency. The company is also testing computer-assisted ordering at the stores which would reduce inventory levels.

New distribution technologies under development in the industry require cooperation between suppliers and retailers. Except for those companies involved in manufacturing their private-label

¹⁴ R. Greenwood. Personal interviews with various supermarket management personnel – United Kingdom and Canada, July 1998.

products, Loblaw purposefully does not engage in partnering with suppliers. Instead, Loblaw actively manages its supplier mix to improve service and efficiency.

It is estimated that Loblaw spends a lower percentage of sales on distribution than its Canadian competitors. This efficient cost control led one analyst to identify Loblaw as being two years ahead of its competitors in logistics. Nevertheless, the same analyst noted that Loblaw has not fully captured the potential benefits of its size and market share. Purchasing and distribution systems still are organized regionally. One industry analyst referred to Loblaw as “Balkanized,” the result of historical growth via acquisition. Annual savings of \$150-200 million (Cdn) are anticipated from a recently initiated overhaul of administration, distribution, and the backroom.¹⁵ Further improvement could follow from enhanced use of point-of-sale (POS) technology as a mechanism for triggering re-stocking.

Labor

In 1997, Loblaw Companies increased the number of unionized employees from 50,200 to 55,700.¹⁶ Many of its newer competitors are non-unionized and have the benefit of lower labor costs and greater flexibility. Loblaw recognizes, however, that the company’s success depends on “the attitude of the employees.” Because in-store service is affected by employee behavior, relationships with unions are important. Recent losses in market share suffered by competitors are the result of labor action. Loblaw monitors its labor costs on a store-by-store basis, producing statistics (such as sales per labor hour) that measure trends in productivity.

In 1998, 27 labor agreements affecting 5,200 employees were due for negotiation, with the largest agreement covering 3,500 employees. Loblaw is seeking long-term contracts in order to achieve “competitive labor costs for the longer term” (*Annual Report, 1997*).

Loblaw has a philosophy of developing its own personnel. For example, the 30 corporate officers listed in the *1997 Annual Report* have an average of 13.5 years of service with the company.

Customer Loyalty

The use of private labels has been a significant contributor to Loblaw’s success. These higher-margin labels now constitute 35 percent of Loblaw’s grocery unit sales, significantly above the industry average of 28 percent.¹⁷ The two most prominent labels are the low-priced “no nameTM,” and the premium quality “President’s ChoiceTM.” The latter is developed in the company’s own facilities and then sent to leading manufacturers for production. To be selected for private-label production, manufacturers must have quality maintenance systems. The success of President’s Choice has spread to the United States where licensing arrangements are in place with several major U.S. retailers.

Unlike many of its competitors, Loblaw has no frequent-customer program. Instead, customers are encouraged to open an account with President’s Choice Financial and use the bankcard to accumulate President’s Choice Points, which are redeemable for groceries.

Loblaw earns customer loyalty by being better than its competitors in the quality and pricing of its products, the attractiveness of its stores, and the relevance of its product range.¹⁸

¹⁵ First Marathon Securities Ltd. Loblaw Companies – Company Report, July 22, 1997.

¹⁶ Loblaw Companies Limited 1997 *Annual Report* p. 7.

¹⁷ First Marathon Securities Ltd. Loblaw Companies – Company Report, July 22, 1997.

¹⁸ Loblaw attends to the quality of all its products. However, particular emphasis recently has been given to expanding the range of fresh produce items. The company is seeking perishables superior to its competitors and has established and enhanced its procurement operations in California, Florida, and Texas.

Performance

The success of the Loblaw strategy is reflected in its increasing market share and stock price. In 1997, Loblaw captured 20 percent of the Canadian market, although market share varied by province. In March 1998, Loblaw opened its first store in Montreal (Quebec) and plans further, gradual expansion into that market. Growth is anticipated in Alberta and British Columbia by adding additional stores and same store sales have been increasing in part due to competitors' strikes in the recent years. The significant capital investment in Atlantic Canada has led to market share increases as well as improved profitability. By competing throughout Canada in retail and wholesale operations, the company manages its exposure to regional and industry economic risk.

Traditional Competitors¹⁹

1. Canada Safeway

Headquartered in Calgary, Alberta, Safeway entered Canada in the early 1930s as the first modern supermarket and by the 1950s had become the dominant grocer in western Canada. In 1996, damaging labor disputes with unionized workers in British Columbia (BC), followed a year later by industrial action in Alberta, cost the company market share. Nevertheless, the company still holds 28 percent of the BC market and 31 percent of the Alberta market largely because of its superior real-estate base.

Safeway is more vertically integrated than its competitors (e.g., in dairy, bakery, and processed fruit and vegetables) and operates 14 manufacturing or processing plants in Canada. New stores focus on the 35-50,000 sq. ft. format because of the company's emphasis on community links. These new stores and remodeled stores have a floral department, garden shop, in-store bakery, deli, and pharmacy services. A drive-through home-meal replacement store is being built in Calgary.

Canada Safeway has strong private brands. The "Select" label covers premium products. Other brands such as "Lucerne" (dairy products), "Edwards" (coffee), and "Empress" (jam), are popular with consumers. Canada Safeway has two customer loyalty programs: Airmiles™ and Safeway cards.

The current challenge to Safeway is managing its costs. Steps taken to reduce costs include closing unprofitable stores, reducing headquarters' personnel, and improving the efficiency of manufacturing operations. The biggest challenge, however, is closing the gap between its relatively high labor costs and those of its competitors.

2. The Oshawa Group

The Oshawa Group, headquartered in Etobicoke, Ontario, is the franchiser in nine provinces for 655 IGA food stores and regionally for 845 Knechtel, Food Town, Bonichoix, and other independent grocers. It operates 105 corporately owned supermarkets, primarily in Ontario and Nova Scotia.

The company grew principally by acquiring regional operations. Only recently have these operations been consolidated into three regional food distribution divisions. Each region piloted different information systems that are being adopted nationally. The central region developed

¹⁹ Competitors information taken from the various competitors published annual reports, industry analyses by various brokerage houses (e.g., First Marathon, Morgan Stanley, Dean Witter), various articles in *Canadian Grocer*, *Supermarket News*, *Progressive Grocer*, *Canadian Business*, *Financial Post*, *Globe and Mail* and *Toronto Star*.

continuous replenishment, the western region developed electronic data interchange (EDI), and the eastern region developed direct-store delivery. The Oshawa Group also will standardize merchandise procurement, human resources, finance, retail store development, and design.

The Group focuses on two markets: wholesale and retail servicing of home-consumption (Agora Food Merchants) and restaurants and hotels (Serca Food Services). The latter is Oshawa Group's response to the growth of ready-prepared foods. Instead of simply selling ready-prepared meals through grocery stores, the Group is supplying alternative food sources. Serca is far and away the largest supplier in its market.

In the home-consumption market, the Oshawa Group emphasizes stores in the 18,000 to 40,000 sq. ft. category with some substantially larger stores. In the competitive Ontario market, two new concept stores have been opened. A traditional 15,000 sq. ft. store in central Toronto concentrates almost 50 percent on fresh produce plus meal solutions. A similar emphasis defines the larger IGA Marketplace in Mississauga. These stores avoid head-on competition with Loblaw. The Oshawa Group has a strong and expanding private-label program, which yields 25 percent of sales. A national marketing organization—Horizon International—markets the program.

3. *Metro-Richelieu Inc.*

Metro-Richelieu is the second largest food distributor in Quebec. Unlike other grocery chains, wholesaling accounts for the larger share of its sales volume (66%). There are 294 Metro supermarkets averaging 15,000 sq. ft., 189 Marche-Richelieu stores, averaging 45,000 sq. ft., located in smaller towns and villages, and 36 Super C discount stores with limited choice but discount prices, averaging 47,300 sq. ft. and located primarily in Montreal. The company services two independent banner chains with 290 stores, averaging 13,000 sq. ft. and has 65 Brunet Pharmacies.

Metro-Richelieu was struggling until 1990 when the current president and CEO was appointed. The new CEO sold the nonfood distribution assets (including the Quebec Nordiques hockey franchise) and refocused the company on food distribution. Tight financial controls and targets were introduced. Stores were remodeled and overall appearance improved. The result has been growth in the Quebec market from 25 percent to 34 percent, fractionally below market-leader Provigo. Although Quebec stores, on average, are smaller than Canadian stores (20,500 sq. ft. vs. 27,500 sq. ft.), Quebec store sales per square foot are 15 percent higher than Canadian stores because neither Provigo nor Metro is motivated to start a price war. Private-label brands have been only recently introduced. Flush with cash, Metro-Richelieu has opened a Metro in Toronto and is looking to expand outside Quebec. In August 1998, the company reported an increase in earnings compared to the corresponding period in the prior year.

4. *Provigo*

Provigo has 35 percent of the Quebec market and intends to double its current 10 percent share of the Toronto market in five years using the Maxi & Co. banner. Pierre Mignault, president and CEO, joined the company in 1993 from Price Costco Canada. Considerable investment in technology has improved productivity, reduced costs, and improved service to customers by speeding delivery of fresh produce. Stores continue to be remodeled and refurbished, and by the end of 1999, 40 percent of Provigo stores will be upgraded. Mignault believes Provigo is competitive on price with Wal-Mart and Zellers.

Provigo operates under three banners. Provigo and Loeb are neighborhood convenience stores with emphasis on fresh and ready-to-eat foods. About 50 percent of these stores are allocated to fresh products rather than the industry norm of 30 percent. Maxi stores, approximately 80,000 sq.

ft, are supermarkets combined with 30,000 sq. ft. of general merchandise. These stores are intended to be the lowest price stores in their market and carry fresh products but no in-store butchers or bakeries. Provigo is expanding the number of Maxis. Maxi & Co. stores offer a broader range of items than Maxis, including 20,000 nonfood items. These stores focus on seasonal products, product demonstrations and sampling, and CD autograph sessions. Products that require service or present inventory problems are avoided. Provigo does not emphasize its private-label brands.

In mid-1997, Provigo sold its chain of 295 low producing convenience stores, including Red Rooster and Winks. Because the Quebec market is not expected to provide significant growth, Provigo is targeting the Ontario market, drawing on the company's strength in technology and efficiency as a potential source of competitive advantage.

5. *Sobeys, Inc.*

Sobeys, Inc., a subsidiary of Empire Company, is controlled by the Sobey family. Empire Company is active in retail and wholesale food distribution, real-estate development (owning shopping centers) and retail pharmacies in Canada and the eastern United States.

Sobeys operates primarily in Atlantic Canada, where it has a 40 percent market share. The company has 130 retail stores, all but 20 using the Sobey banner. Stores range from 15,000 sq. ft. to over 50,000 sq. ft. New stores are of the larger format.

Sobeys investment in distribution technology has made the company cost competitive. Most of its stores have been upgraded and made attractive. Private-label brands, based on the premium "Our Best," and the value-priced "Signal," are well received. More importantly, Sobeys prides itself on staying close to its customers by understanding their distinctive regional preferences.

Despite the entry of Loblaw and Provigo into Atlantic Canada, Sobeys has retained its market share but has suffered reduced margins. Sobeys is moving steadily into the Ontario and Quebec markets, opening about two stores per year.

6. *Overwaitea Food Group*

Based in Langley, BC, Overwaitea, privately owned by the Jim Pattison Group, is one of the largest chains in western Canada, and promotes itself as a locally based company. Overwaitea operates two retail chains: 42 Overwaitea stores located in BC, but not in Vancouver or Victoria and 29 Save-on-Foods & Drug Stores located in urban areas of BC and Alberta. Associated Grocers, the distribution and wholesale division that supports the retail chains, is based in Calgary. In addition, Associated Grocers serves 500 independent retail and convenience stores throughout Alberta and BC.

The Jim Pattison Group also operates Buy-Low Foods, a 36-store chain acquired in 1995. Buy-Low Foods has its own wholesale operation that serves 300 independent BC retailers.

Overwaitea's market thrust is based on the large format (up to 78,000 sq. ft.) Save-On-Foods & Drug Stores. The format is a one-stop, full-service outlet with a pharmacy, florist, dry-cleaner, bookstore, shoe repair service, travel agency, fast food restaurant, and coffee shop. The company, however, emphasizes the quality of its private-label products and knowledge of food. Older stores are being refurbished.

Overwaitea has invested heavily in technology and was the first to convert to 100 percent scanning. All stores and distribution facilities are linked electronically. The company considers customers as "our" customers and advertises extensively appealing to the western Canadian sense of family. Overwaitea has a strong customer loyalty program using a "Save-On-More Card."

The company is unionized and suffered similar strikes and consequent loss of market share as Safeway in 1996 and 1997.

7. The Great Atlantic and Pacific Company of Canada Ltd. (A&P Canada)

A&P, a U.S.-owned company, operates exclusively in the Ontario market, where it has a 15 percent market share (down from 20 percent in 1990). Initially, A&P's strategy was to service the suburbs and other secondary markets but when the company acquired Dominion stores and Ontario's Miracle Food Mart, it began to compete openly against all Ontario chains.

The recession of the early '90s, the entry of warehouse clubs, and the steady renaissance of Loblaw, has affected A&P's sales growth. A&P lost market share following a 14 week labor dispute in 1994.

A&P has streamlined its banners. "Dominion" and "Dominion Plus" are retained in major urban areas with competitive pricing and wide selection, and "A&P" stores have a similar focus in the rural areas. "Super Fresh" is a warehouse/supermarket format with lower wages and part-time employees. "D-Save-a-Centre" is a more limited selection format of the Dominion stores. "Basics" is another limited selection discount format. As of this writing, the superstore concept has not been used.

The company is close to reaching its target of 25 percent of sales from private labels. A competitive strength is the expertise in information technology obtained from the U.S. parent. The company was an early adopter of category management, POS, couponing, and targeted mailings. A&P holds the Ontario grocery store rights to Canada's most popular frequent shopper program, Airmiles™.

Changing Industry

Competitive pressures in the grocery industry are likely to increase. Several new competitors, including Wal-Mart, have or may enter the market. New methods of delivery—especially the Internet—are challenging traditional store-based approaches. Customers are becoming increasingly demanding in their preferences, and there is the rising likelihood of an escalating price war in Ontario.

New Competitors

Loblaw faces competition not only from traditional grocery chains but also from less traditional outlets. *The Canadian Grocer* (Jan-Feb 1998) estimated that drugstores have 3 percent and warehouse clubs have 7.5 percent of the grocery sales market. Specialty stores (bake shops, meat shops, health food stores) and department stores have approximately 8 percent of the market. The 81.4 percent market share held by traditional grocery and supermarket outlets in 1997 is significantly less than the 93.2 percent market share held in 1994.

A real threat to traditional grocers is the possibility of Wal-Mart, and other nontraditional outlets, such as Shoppers Drug Mart and Save-on-Drugs, moving more broadly into the Canadian market. Currently, Loblaw and Wal-Mart overlap only slightly. In the United States, however, Wal-Mart is experimenting with its first full-fledged supermarket that could give the giant discount retailer an even bigger piece of the huge grocery business. “Wal-Mart Food and Drugs Express” includes a drive-through pharmacy, a deli counter, a produce section, and aisles for such merchandise as health and beauty aids. One analyst predicts Wal-Mart will be the largest U.S. food retailer by 2004.

For the moment, Wal-Mart has denied rumors concerning its intent in Canada. However, Wal-Mart has expanded the food sections at some stores in Ontario. The addition of refrigerated grocery products—including milk, cheese, juice, and hot dogs—has some observers anticipating the introduction of Wal-Mart’s “supercenter” format to Canada. Supercenters are divided between groceries (32%) and general merchandise (68%).

Should Wal-Mart develop the supercentre (130,000 sq. ft.) concept within Canada, it is likely that regional chains, such as A&P (Canada) and Metro-Richelieu Inc., would be harder hit than national chains and/or those with robust private labels. Wal-Mart is renowned for its technologically sophisticated distribution system and its ability to control its costs. Wal-Mart is well known for its low distribution costs. Should Wal-Mart decide to enter the Canadian grocery market, Loblaw will be ready with plans for squeezing inefficiencies from its cost structure especially in the area of distribution. To enter Canada successfully Wal-Mart would need prime locations, which in 1998 were not readily available, especially in the Ontario market. Loblaw is monitoring the availability of advantageous real estate. Another possibility would be for Wal-Mart to acquire an existing chain.

Other competitors include the large drug chains, such as Shoppers Drug Mart, who sell grocery produce as loss leaders and use dry foods as a replacement for tobacco products. Relatively new competitors are the warehouse clubs (e.g., Costco) offering a wide range of products with minimal service at deep-discounted prices. According to AC Nielsen, the number of shopping trips to warehouses increased in one year by 21 percent and spending increased by 19 percent during the same period.

Internet Shopping

Internet shopping for groceries is not extensive in Canada. In the United States, NetGrocer (see Box 4) has pioneered its introduction (using FedEx for delivery). As of December 31, 1997, statistics were not yet available on the scale or profitability of an online grocery store. In 1997, a survey conducted by *The Canadian Grocer* found that 12 percent of Canadian consumers expressed an interest in ordering groceries by fax or the Internet. Interest was highest (23%) in the 18-24 age group. Across Canada, several stores currently accept faxed orders but Loblaw does not. However, it remains watchful of issues such as E-commerce. According to a recent survey by AC Nielsen and Nordicity Group Ltd., approximately 20 percent of Canadians can access the Internet, making it “one of the fastest growing communications and marketing mediums.” Nielsen anticipates that by the year 2000 as much as 20 percent of all groceries will be purchased electronically.

Ontario Price War

The Ontario marketplace is the largest in Canada but is becoming “the most competitive food retailing market in North America.”²⁰ The actions of some of Loblaw’s competitors have begun to affect the Ontario marketplace. In the past 18 months, A&P has converted a number of stores to the “Basics” banner, a discount format that has cut into the sales and margins of all competitors. The conversion of the Oshawa Group’s Food City stores to the IGA banner has further increased competition in the more traditional supermarket segment.

Box 4



www.netgrocer.com

Welcome to our new site. We've listened to your comments and are continually working hard to make NetGrocer better for you.

These are some of our new features that you will find in this version of NetGrocer.

- Faster and more efficient product shelf displays.
- A more intelligent search engine which allows you to narrow your selection.
- Our multi-item search feature formerly known as The Shopper has been renamed to Shopping List and includes the greatly enhanced functionality of our more intelligent search engine.
- As a result of this name change, the feature formerly known as Shopping Lists has been renamed Saved Carts and its interface has been improved to allow for more intuitive use and the preserving of a shopping session over several consecutive visits. Improved site menus which put commonly used functions (including search) in a toolbar at the top of the page for instant access.
- Faster Department/Aisle/Shelf navigation by replacement of our tabbed menus with updated link style menus and a new pull-down navigation option which maximises product display space (note: you may change menu modes from the link at the bottom of our home page).
- A greatly improved My NetGrocer function which allows you to shop based on your past shopping history. For your convenience, My NetGrocer has also been integrated into each aisle you visit.
- Net Grocer is now much more screen friendly since we have increased our font sizes and made key navigational frames resizable and/or scrollable. We've also added a 640x480 mode for those with low-res VGA settings and a 1024x768 and more mode for those with the latest and greatest hi-res setup. Check out the easy to use control at the bottom of our home page.
- Plus, many other enhancements which make this the fastest version of NetGrocer yet.

Please note that we appreciate your feedback and want to know your thoughts about further improvements and enhancements. Tell us what you like, and what you don't like. We'll continue to listen and improve. To give us your thoughts or to report a bug, please use the link below.

²⁰ *Financial Post*, Aug. 26, 1997.

Conclusion

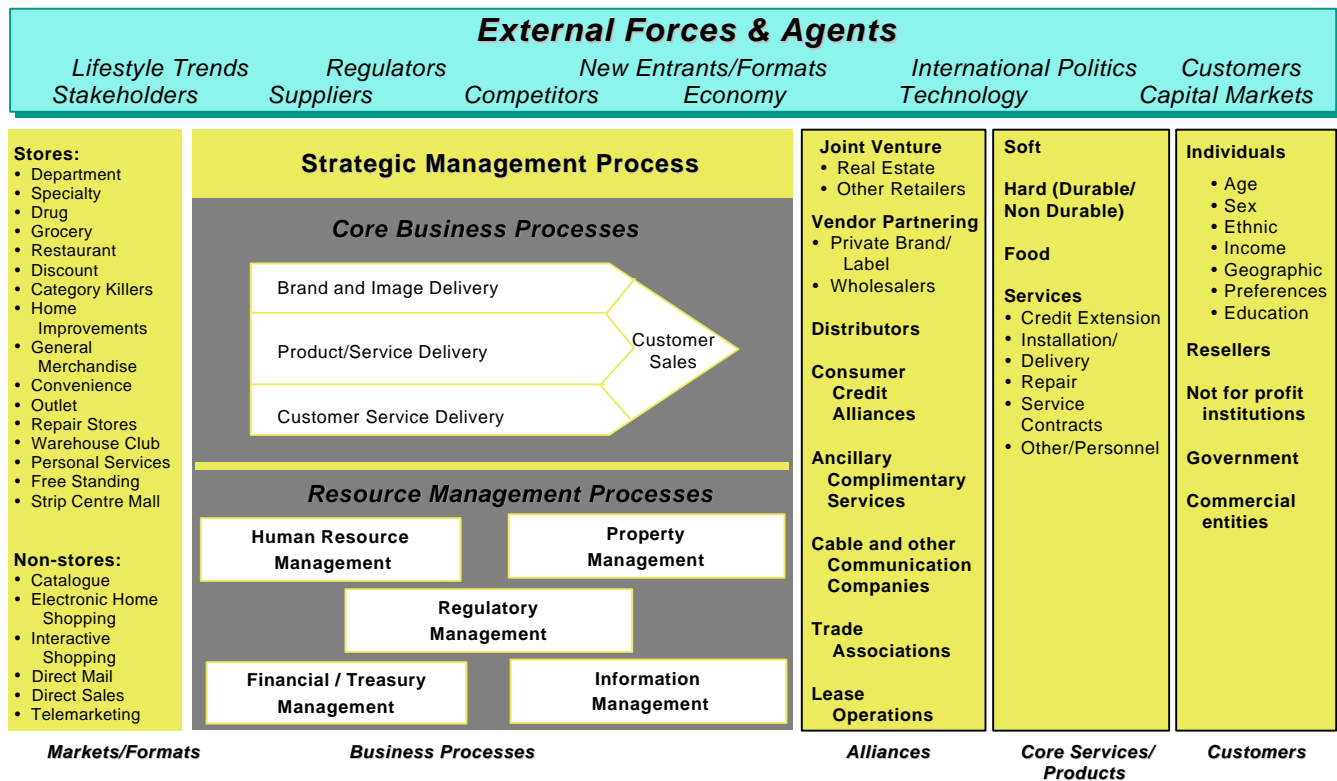
The grocery industry is healthy, with high demand and as George Condon, editor-in-chief of *The Canadian Grocer*, notes, “People will always have to eat.” But the maturity of the industry, characterized by flat demand combined with the growth aspirations of the dominant suppliers makes the industry a competitive battleground. Competitors work toward driving costs down while responding to swiftly changing consumer tastes. Grocery managers, therefore, are challenged to provide the marketing mix of tomorrow, emphasizing speed, flexibility, and early identification of trends directed at segmented and rapidly evolving markets. The mass consumer market has been replaced by hundreds of highly diversified mini-markets for which grocery companies have to design custom-made solutions.

Condon believes that, “there will be many victims over the next two or three years as the industry rationalizes,” a sentiment echoed by CIBC industry analyst David Brodie, who believes that there is “too much square footage chasing not enough stomachs.”

Figure 2 presents the KPMG Industry Segment Business Model for a retail client, including a client operating in the grocery industry. This model is used by Mary Lou and her team as a starting point to prepare a customized entity-level business model for Loblaw.

Figure 2

KPM G Entity-Level Business Model for a Retail Client



Part II

Business Process Analysis

Mary Lou and her staff have tentatively concluded that Loblaw has adopted a business strategy whereby it is a low cost provider of groceries and related goods and services. Loblaw combines this low cost strategy with an attention to product differentiation (e.g., private labels such as President's Choice™) and process differentiation (i.e., store layouts). Because the grocery industry is a commodity industry in which it is difficult to sustain differentiation cost leadership is critical. During the discussion between Mary Lou and her team members they consider the link between the entity's strategy, related business objectives, and the actions that need to be taken inside the business processes that make up the business and its interaction with outsiders. They employ in this analysis a KPMG training document which provides a starting point for thinking about the links between a cost leadership strategy and its effects on various functional areas. (See Box 5.)

Box 5

Implications of a Cost Leadership Strategy for Selected Functional Areas*

Functional Area	Strategy Description
Purchasing and materials management	Purchase at low cost through quantity discounts. Operate storage and warehouse facilities and control inventory efficiently.
Production/operations management	Emphasize operation efficiencies through learning, economies of scale, and capital-labor substitution possibilities.
Research and development	Emphasize process R&D aimed at reducing costs of operations and distribution.
Information systems	Emphasize timely and pertinent information on costs of operations.
Marketing	Emphasize low-cost distribution and low-cost advertising and promotion.
Human resource management	Emphasize reward systems that encourage lowering of costs.

* An extract from a KPMG corporate strategy training document.

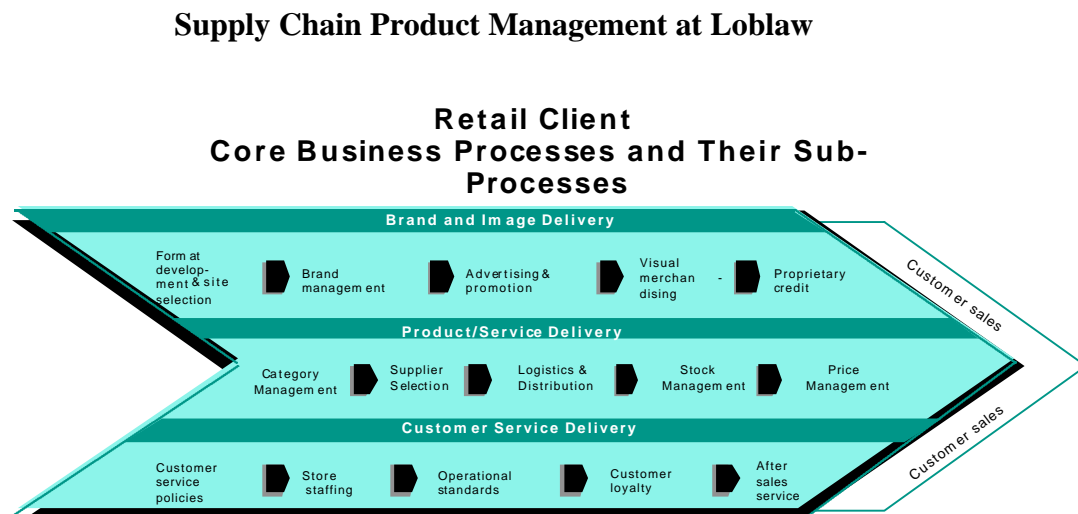
Mary Lou and her team also summarized the core and resource management processes that comprise a retail grocer (see Figure 2 and Appendix I for a description of those processes). Mary

Lou reminds her team that they need to focus their attention on those processes with significant business risk, because it is those processes that are the most likely sources of audit risk. These processes, known as key business processes, are determined by assessing the following criteria in the context of the client’s objectives and strategy:

- *Strategic relevance of the process:* Assess the importance of the process given management’s strategy.
- *Inherent risk of the process:* Consider the complexity of the process, the extent of managerial judgment involved in the process, and prior auditor experience with auditing the process or related financial statement items.²¹
- *Control environment of the process:* Assess the strategic controls, management controls, and detailed process-level controls.

After much discussion, Mary Lou and her managers decide to examine in more detail the product/service delivery process, referred to at Loblaw as supply chain product management. The team believes that these processes may contain significant business risk and, therefore, audit risks.

Figure 3



To acquire more knowledge of the supply chain product management process, Mary Lou and her team decide to conduct a series of interviews with various managers and associates at Loblaw who are responsible for the decisions, activities, and controls within this business process. In preparation for the interviews, the audit team breaks down the supply chain management process into Loblaw’s five subprocesses. (See Box 6 and Appendix II for a description of subprocesses).

²¹ Note the strategic lens concept of inherent business (or process) risk is broader than the traditional audit conception of inherent risk as “the likelihood of a significant misstatement occurring, ignoring the effect of internal control.” However, it has always been understood that audit risk is conditional on client business risk. For example, AU Section 312 in the U.S. authoritative guidance states that “External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.”

Mary Lou starts the series of interviews by speaking with Richard J. Currie, president and Stephen A. Smith, senior vice president and controller. Mary Lou summarizes these interviews for Mark and Laura by telling them, “Supply chain performance measures monitored by senior corporate management include distribution costs per case, inventory turnover ratio, and on-time delivery to stores.” Mary Lou reports that senior corporate managers only review a small subset of the performance measures employed by the process managers.

Mark and Laura each select members of the supply chain product management team to interview and later summarize the results in a series of workpaper memos.

Summary of Category Management Interviews

The Loblaw category management team determines which stock keeping units (SKUs) within each product category to sell. Current strategies include adding private-label (e.g., “President’s Choice™”) products where appropriate.

Two principal management techniques are employed: (1) comparing product sales in stores with similar demographic markets (especially new stores) that over time can suggest changes in category product mix for a store and (2) using industry data collected by AC Neilson, an independent market research firm. AC Neilson collects data from all major grocery retail chains in Canada and makes it available in aggregated form. This approach allows each grocery chain to know its market for its specific products by geographic region.

Box 6

**Supply Chain Product Management
Overview**

Significant business processes:

- Category management
- Supplier selection
 - Private-label manufacturers
 - National brand
- Logistics and distribution
- Stock management
- Price management

The performance indicators monitored by category managers in the industry include sales per square foot, change in sales per square foot in comparable stores, customer satisfaction survey index, and individual category manager performance index. See Table 3 for a summary of performance measures and how they are calculated.²²

Summary of Supplier-Selection Management Interviews

Supplier selection involves selecting the manufacturer of the private-label products and selecting the national/regional brands to be carried in the various retail stores. This subprocess includes developing new products.

Private-label manufacturers: Based on category analysis and management’s “gut feeling,” Loblaw develops private-label products when it finds a market niche within a category where the consumer will purchase a product that is not a national brand. Loblaw can introduce either a premium private-label product (President’s Choice™) and/or a generic (no name™) product. The

²² To protect the confidentiality of Loblaw’s specific performance measures, which are considered proprietary by Loblaw’s management, all performance measures cited in the case are based on measures found in KPMG’s retail business model. Therefore, reference is made in the case to performance indicators normally employed in the industry.

Table 3
Performance Measures for Supply Chain Product Management at Loblaw

Performance Measures	Formula
<i>Category management</i>	
1. Sales per square foot	1. Sales/store square footage
2. Change in sales per square foot in comparable stores	2. $\frac{(\text{Sales}_{\text{period2}} - \text{Sales}_{\text{period1}})}{\text{Sales}_{\text{period1}}}$
3. Customer satisfaction survey index	3. Based on a survey carried out quarterly by independent research firm
4. Individual category manager performance index	4. Composite performance index of a number of personal productivity items
<i>Supplier selection – ongoing</i>	
1. Percentage of orders delivered correctly	1. $\frac{\# \text{ of orders correct from a vendor}}{\text{Total \# of orders to a vendor}}$
2. On-time delivery percentage	2. $\frac{\# \text{ of orders on time from a vendor}}{\text{Total \# of orders to a vendor}}$
3. Lead time for product delivery	3. # of days vendor needs in advance of the delivery date to ensure on-time arrival
<i>Logistics and distribution</i>	
1. Distribution costs per case	1. $\frac{\text{All distribution center costs plus delivery costs}}{\text{Total \# of cases processed by distribution center}}$
2. Inventory cross-dock percentage	2. $\frac{\text{Units of goods shipped via cross docking}}{\text{Total units of goods shipped via distribution center}}$
3. Number of errors in “picking” inventory per order	3. $\frac{\text{Total picking errors per day}}{\text{Total orders processed per day}}$
4. Percentage of orders filled completely	4. $\frac{\text{Total orders completely filled per day}}{\text{Total orders processed per day}}$
5. On-time arrivals of vendors trucks at distribution centers	5. $\frac{\# \text{ of trucks arriving on time}}{\text{Total trucks scheduled to arrive}}$
6. On-time arrivals of distribution center trucks at stores	6. $\frac{\# \text{ of trucks arriving on time}}{\text{Total trucks scheduled to arrive at store}}$
<i>Stock management</i>	
1. Inventory turnover rates	1. $\frac{\text{Cost of inventory distributed by distribution center}}{\text{Average inventory (at cost) held at distribution center}}$
2. Inventory levels	2. Actual level of inventory on hand vs. budget
3. Sales to predicted sales ratio	3. $\frac{\text{Sales of product}}{\text{Predicted sales for product}}$
<i>Price management</i>	
1. Gross margin by category	1. (Sales price – cost of goods) by category
2. Actual mark-downs vs. planned mark-downs	2. # of products marked down – # of products marked down per budget
3. Comparative store sales vs. new store sales by category	3. A) Match old stores to new stores by demographics B) Sales per category difference between old and new stores
4. Market share by category	4. $\frac{\text{Store sales per category}}{\text{Market total sales per category}}$

principal differences between the two are product quality and unique features (i.e., a premium product has higher quality than the leading national brand and may incorporate some features that cannot be replicated easily by competitors). The company seeks bids from manufacturers to produce, under contract, a Loblaw private-label product. Loblaw benefits in two ways from having private labels: products only are available at its stores and the markup is more consistent and less volatile on these products than from national brands, a commonly cited advantage to private-label products.

Some of the factors Loblaw considers when selecting private-label manufacturers are their previous experience producing the product, technological capabilities, financial condition, and ability to meet Loblaw's quality standards. On an on-going basis, supplier-selection managers in the industry monitor the vendor's delivery accuracy (percentage of orders correctly delivered), on-time delivery percentage, and lead-time for product delivery (see Table 3).

National brand: The introduction of new national/regional brand products tends to be based on supplier "pitches." Vendors throughout the industry constantly attempt to persuade grocery chains to "carry" new product items. In a recent year, Loblaw's vendors presented almost 22,000 products of which 4,000 to 5,000 were selected for trial. As part of the supplier's "pitch," information is provided about how the product will be positioned, its suggested retail price and wholesale cost to Loblaw, and its sales potential. Generally speaking, Loblaw requires the vendor to choose which products to replace in order to make room for the new item.

Performance assessment of new products occurs after six months and is based on sales volume, profit margin, and change in overall profitability of the product category. Supplier-selection managers in the industry monitor national brand vendors in the same way that they monitor private-label vendors (see Table 3 for performance measures).

Summary of Logistics and Distribution Management Interviews

The logistics and distribution management team ("physical distribution" in Figure 3 and Appendix II) is responsible for inventory movement at Loblaw. The team determines whether inventory will be delivered to the retail stores by direct shipment from the vendor or through Loblaw's distribution centers. The buzz words for Loblaw's logistics and distribution are "fast, fresh, and quality" signifying that Loblaw wants the best mix of fast delivery to retail stores, the freshest product available to the customer, and the best value for the customer's money.

Loblaw is in the middle of a multi-year program to reduce logistics and distribution costs per case substantially through a combination of leveraging volume growth and operation process changes. A key part of this initiative is to address supply chain costs by shipping from Loblaw distribution centers to stores instead of directly from vendors to stores.

The movement of goods from vendors to grocery stores is a complex process involving several options. A grocery chain has to decide whether to have goods delivered to one central distribution location and then sent to other distribution centers, use commercial carriers or their own fleet to pick up goods from vendors, or have vendors deliver goods to various distribution centers. To assist in the decision-making process, Loblaw requests that vendors give price quotes for the various distribution options.

Consistent with industry practice, Loblaw is continuing its efforts to increase the amount of flow-through and cross-docking at its distribution centers. Flow-through requires the vendor to break

down their products into “store-ready” skids (i.e., each skid contains all products from the vendor going to a specific store). Flowthrough allows the product to move from the vendor truck across the loading dock into the Loblaw truck going to the store. Cross-docking means a product arrives in the warehouse and departs for the stores on the same day. Cross docking requires that vendors make their deliveries to Loblaw on a very tight schedule.

Loblaw has been revamping its inventory management system for three reasons. First, some of the systems were not year 2000 compliant. Second, as a result of Loblaw’s fast growth, systems were not fully integrated resulting in some manual data transfer between systems. Third, Loblaw management wanted faster inventory updates and easier tracking of the performance measures that it monitors.

In general, logistics managers track six performance measures. These measures are the distribution costs per case, percentage of goods shipped by cross docking, number of errors in “picking” inventory per order, percentage of orders filled completely, and proportion of on-time arrivals of distribution centre trucks at stores (see Table 3). Performance measures are monitored weekly for each distribution center. Management examines all measures that fall outside of expected ranges to determine potential causes and to take corrective action, if necessary.

Summary of Stock Management Interviews

Once vendors have been chosen, the stock management group determines the amount and timing of product orders. In conjunction with logistics and distribution, stock management establishes inventory levels for each of the distribution centers (i.e., warehouses). The key buzz words for stock management in the industry are “days supply,” which means the number of days of inventory in a given distribution center. The most important aspect of managing stock is accurately forecasting consumer demand for the product. The ability of the stock-management team of any grocery chain to forecast stock-level requirements accurately has a direct effect on costs, because of inventory holding costs, which are included in cost of sales, and the opportunity cost of lost sales, which is potentially even more important.

Loblaw makes three types of purchases, each of which calls for a different type of forecasting. First, regular buys are targeted to keep inventory in the distribution centers at specified levels. Buyers use a computerized inventory order support system that automatically suggests orders. Second, buyers engage in promotional buys of extra stock to meet increased demand during a sale period. Finally, buyers can forward purchase when a supplier notifies Loblaw that a product will be subject to a price increase in the near future. Stock managers decide whether to purchase extra inventory before the price increase.

Stock managers in the industry regularly monitor inventory turnover rates, inventory levels, and the sales-to-predicted-sales ratio (see Table 3). Some products are monitored daily while others are monitored less frequently.

Summary of Price Management Interviews

The goal of the price management team at Loblaw is to ensure that Loblaw meets its commitment to competitive pricing while maintaining a profitable, growing business. In meeting this objective, Loblaw’s price-management team carefully prices each product in a category and considers relative price relationships within the category (i.e., Loblaw’s private-label products

priced below national brands in any category) and for substitute goods (i.e., instant coffee vs. ground coffee).

To ensure competitive pricing, Loblaw carries out a program of extensive price checks at competing stores in each of its markets. Managers at the individual store level have the ability to reduce prices to meet or beat the competition. Higher level management checks these changes on a regular basis to decide if a company-wide price decrease is needed.

Price managers regularly monitor gross margin by category, actual versus an acceptable level of markdowns in price, category sales in similar demographic areas for existing stores compared with new stores, and overall market share at the store and category level (see Table 3). Loblaw manages these indicators on a weekly basis consistent with typical retail grocery industry practice.

Risk Assessment of Supply Chain Product Management

In considering the five subprocesses comprising supply chain product management at Loblaw, Mary Lou and her team conclude that the logistics and distribution subprocess is a particularly high-risk area that warrants careful attention. The team develops and documents its conclusions based on the three criteria for selecting key business processes:

1. Strategic Relevance of Logistics and Distribution

Loblaw management's decision to be a low-cost distributor of retail groceries and related products implies that all costs relating to inventory must be managed carefully. As the *1997 Annual Report* states, "Supply chain product management, a process to manage inventory from supplier to end consumer in the most efficient and cost effective manner, continues to be an area of focus throughout the company." Further, as noted in the *Annual Report*, the possible entry of Wal-Mart and other new food competitors (e.g., drugstores) into the retail grocery market is perceived by Loblaw's management to be a strategic threat. Wal-Mart is well known in the retail industry as having the most efficient and low-cost distribution system and as with other new competitors may use grocery items as loss leaders. In response to this strategic threat, Loblaw entered into a major strategic initiative to reduce its distribution costs substantially. Furthermore, all of Loblaw's traditional competitors are attempting to reduce their distribution costs. Therefore, even if Wal-Mart does not enter the market, Loblaw, by reducing distribution costs, would be better positioned to sustain its current competitive advantage.

Mary Lou consulted a North American grocery industry expert about the strategic relevance of logistics and distribution. This discussion confirmed the preliminary assessment that supply chain product management is a key source of competitive advantage in the retail grocery industry. Furthermore, the industry expert agreed that logistics and distribution is an important element of any strategic advantage generated from supply chain product management.

2. *Inherent Risk of Logistics and Distribution*

Inventory ordering is a complex task based on factors such as time of year, advertising promotions, and response to competitors. This requires significant managerial judgement that raises inherent process risk.

Receipt of inventory from hundreds of suppliers needs to be managed daily at warehouses and at retail stores. Loblaw faces a variety of choices about how to receive that inventory—direct delivery to the retail store, delivery to one of Loblaw’s distribution centers for traditional inventory, or delivery to a distribution center on a cross docking or a flow-through basis. For the latter three categories, Loblaw faces additional decisions about delivery to the retail stores: via its own fleet or through commercial contractors. This area was the target for substantial cost reduction and rationalization requiring the adoption of many new operating practices. Process complexity and current changes to reduce costs increase inherent process risk.

Loblaw’s inventory largely consists of fast-turnover food and related items. Accordingly, Loblaw has not established routine procedures to identify obsolete inventory. During last year’s audit, KPMG carried out a number of procedures to obtain assurance about inventory obsolescence. The end result was a number of minor adjusting entries that were accepted by Loblaw’s management. While inventory obsolescence is not a primary concern when the auditor considers logistics and distribution, insufficient management attention would raise concern about inherent process risk. Based on the high degree of managerial judgment and process complexity, the audit team concludes that there is a moderate level of inherent risk in logistics and distribution.

3. *Control Environment of Logistics and Distribution*

The team believes that there may be risk associated with the client’s information systems and, in particular, with changes being made to those information systems. As noted in the *1997 Annual Report*, a number of critical operating systems were converted or modified to ensure year 2000 compliance. Industry analysts perceive some inadequacies in Loblaw’s current information systems. The current set of *ad hoc* systems has been attributed to the growth via acquisition that characterized the company’s early years. Both the nature of *ad hoc* information systems and the large-scale systems conversion project lead the audit team to conclude that process-level controls may be potentially weak, which indicates a moderate level of control risk.

Completing the Audit of Logistics and Distribution

Mary Lou assigns Mark responsibility for completing the audit of logistics and distribution. She reminds Mark that a key reason for auditing logistics and distribution is to aid in evaluating management’s assertions about inventory and cost of goods sold as reported on the financial statements. Mary Lou concludes her instructions by stating, “To the extent that Loblaw has any significant residual business risks related to logistics and distribution, we need to assess their impact on the financial statements. I would like you to document conclusions about residual risks and propose any additional testing we may need related to inventory and cost of goods sold.”

As an aid, Mark reviews those portions of the previous year’s audit plan that involved inventory. (See Box 7 for audit plan extracts.) Mark observes that last year’s audit was more traditional in approach and the focus of the audit team’s analysis was on financial statement outcomes as

opposed to business activities and processes that determine the outcomes. Mark concludes that last year's inventory workpapers are of little use in determining how to audit the logistics and distribution process this year.

Box 7

Extracts from Previous Year's Inventory Audit Plan

Inventory analytical review

Compare with prior year and investigate significant variances:

- Inventory levels at individual warehouses.
- Inventory turnover ratios by warehouse and on a category basis.
- Inventory levels on an individual store basis and by category within store.

Inventory existence

- Attend a count at a sample of retail stores to test key controls over count.
- Test key controls over cycle-count procedure.

Inventory valuation

- Pick a sample of items and test current cost based on latest receiving report with inventory cost reported at year-end. Follow-up any significant differences.
- Follow-up on the valuation of any items noted as obsolete, damaged, or slow moving at count observations.
- Examine gross margins in first month of next year by product category to determine if any are significantly lower than last month of previous year.
- Identify all inventory that has been in warehouses for longer than six months. Follow-up with management to ensure an allowance has been made for obsolescence consistent with this analysis.

Appendix I

Core Business Processes Description

Brand and Image Delivery

This core process contains the key elements of translating the strategic plan to operational plans. It includes choices about format/distribution channels, lines of business, and all matters relating to the communication and presentation of the company that might affect a customer's perception. Basically, this process deals with high-level questions about engaging potential customers' interest in a company.

Product/Service Delivery

This core process contains the key elements of the supply chain from determining product/service mix through delivery of product/service to customer. This process deals with all aspects of the provision of goods and services including pricing to the point where the customer is ready and able to purchase them.

Customer Service Delivery

This core process contains the key elements for the delivery methods that contribute to the customer's perception of the company. This process deals with how the company is able to convert its capacity to deliver product/services to the actual sales of these products/services and what level of service is provided after sale.

Resource Management Processes Description

Human Resource Management

This resource management process includes all activities associated with attracting and retaining employees. It also includes overall issues of employee evaluation, motivation, and compensation.

Property Management

This resource management process includes all activities with respect to obtaining and maintaining necessary physical locations for offices, warehouses, and retail stores.

Regulatory Management

This process includes all issues associated with complying with relevant laws and regulations. It may include a risk management function as well.

Financial/Treasury Management

The traditional focus of the audit is found in this resource management process. The process includes budgeting, transactions processing, investment/debt management, and internal/external financial reporting.

Information Management

This resource management process includes all information technology management decisions from business requirements through implementation, maintenance, and ongoing support to users.

Appendix II

Product/Service Delivery Subprocesses

Category Management

This subprocess is designed to translate the larger line of business decisions into specific assortment of products and services offered through specific retail formats (e.g., retail stores, warehouse stores).

Supplier Selection

This subprocess is employed to determine what suppliers will be used for the various goods/services that the retailer will stock. Within the larger decision already made of what lines of business the retailer will be in, this subprocess develops new product/services from idea stage to launch stage. This subprocess would include considering whether to manufacture a product in-house or seek vendors to produce it.

Logistics and Distribution

Providing merchandise/services to the customer at the right time, at the right place, and at an appropriate cost is the goal of this subprocess. This subprocess deals primarily with the physical provision of products and services, while the stock management subprocess determines what products will be provided.

Stock Management

The goal of this subprocess is to optimize merchandise with respect to timing and selection by deciding what goods and services to order and when to have them available for sale. The distribution subprocess then must move the goods.

Price Management

The goal of this subprocess is to set the price for individual products/services consistent with the brand/image objectives already established by the company.