KPMG

Channel stuffing

A growing risk for Middle East consumer and healthcare businesses

Our recent experience in the Middle East suggests that global businesses that conduct sales through their regional distributors are still vulnerable to the risk of channel stuffing. This practice, whereby excess inventory is pushed onto distributors and retailers to artificially inflate sales figures, can have serious consequences for businesses and their stakeholders.

This is not limited to specific industries. However, we have noted that pharmaceuticals, consumer goods (including electronics and automobiles), Oil and Gas equipment providers, and technology companies are particularly prone to the risk.

We have identified two root causes that contribute to channel stuffing in the Middle East. Firstly, the pressure to meet sales targets often compels companies to push their products onto distributors and customers even when there is no genuine demand. This can lead to excess inventory and financial losses for all parties involved. Secondly, a lack of transparency surrounding commercial commitments is a significant factor contributing to channel stuffing. Companies may offer incentives to channel partners to encourage them to stock products, but these commitments are not always transparent. Consequently, channel partners may end up with excess inventory, leading to financial losses and damaged business relationships.

Financial impact of channel stuffing

Revenue overstatement

Under Generally Accepted Accounting Principles (GAAPs), revenue recognition is contingent upon fixed or determinable prices during the sale transaction. Companies are expected to recognize revenue by properly factoring in the transaction price of identified performance obligations, which may include variable considerations such as refund liabilities and anticipated price concessions. Furthermore, after each reporting period, the estimated transaction price should be reevaluated to reflect present circumstances or changes in circumstances.

Channel stuffing is a business practice that can lead to increased exposure for companies in the form of promotional expenses, rebates, subsequent discounts, stock expiries, obsolete inventory-related compensations (including returns), delayed and doubtful collections, and more. Our experience in the Middle East has shown that such variable considerations are frequently extended to distributors and customers, both through contractual agreements and customary business practices that include verbal commitments and side agreements. Unfortunately, companies often fail to accurately account for variable considerations during a reporting period, leading to overstatement of revenue and profits.

Future profit warnings

When companies engage in channel stuffing, it may appear to boost their reported revenues and profits. However, auditors, market analysts, and regulators frown upon such practices as they can distort the investors' and stakeholders' expectations. Channel stuffing involves flooding the distribution channel with more products than the market demand, thus artificially inflating the sales numbers.

If a company engages in channel stuffing and later needs to destock, it may issue a profit warning, acknowledging the need to adjust earnings expectations due to the mismatch between reported sales and actual market demand. Such a move can lead to restatements and regulatory actions. In 2023, some large international companies faced significant share price declines due to profit warnings caused by destocking.

In the post-Covid era, companies reset and sold large inventories in the distribution channel on the back of a positive outlook. However, this has led to high stock levels that are now affecting their ability to accelerate sales further. These companies are facing challenges in moving the existing surplus inventory, and this situation may lead to price cuts, pressure on margins, and a hit to their overall financial performance.

Addressing the issue

To mitigate the risk of channel stuffing, companies operating in the Middle East would be well advised to take proactive measures including:

- Developing and implementing robust internal controls within the sales and supply chain functions to identify any potential issues before they escalate.
- Tracking distributors' inventory levels, sales data, and promotional expenses on a weekly basis to detect any unusual patterns that may indicate channel stuffing.
- Ensuring that distributors' are fully aware of their obligations and responsibilities. This can be achieved by providing clear guidance on the acceptable levels of inventory and sales targets, as well as conducting regular training sessions to reinforce these expectations.
- Initiate timely corrective actions including destocking and recording of accruals for any anticipated increase in trade spending.

We have observed that regional business leaders in the Middle East are now focusing on early detection measures to prevent the practice. To achieve this, companies have implemented data analytics programs and reporting dashboards to regularly monitor distributors' market performance. These programs help identify suspicious sales patterns, such as sudden increases in sales volumes or a higher inventory turnover rate than usual. To facilitate this monitoring, companies have mandated that distributors upgrade their financial reporting systems to allow concurrent reporting of product-level transactional sell-out and distributor stock data.

Moreover, there has been a shift in strategic objectives, with regional business leaders incentivized to focus on inventory optimization to ensure net margins compared to topline growth targets. This means that instead of solely focusing on increasing sales, companies now aim to optimize their inventory levels to maximize profits. As a result, regional leaders are implementing phased destocking plans for markets with high inventory, which involves gradually reducing inventory levels to avoid a sudden drop in sales.

Overall, these measures indicate a growing awareness of the importance of transparency and accountability in the Middle Eastern business community. By adopting early detection measures and implementing inventory optimization strategies, companies are better equipped to maintain sustainable growth and build trust with their stakeholders

Contacts

Nicholas Cameron
Partner, Head of Forensics
KPMG Lower Gulf

Alexander Tuscano
Technical Director, Forensics
KPMG Lower Gulf

kpmg.com/ae I kpmg.com/om

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