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New concepts in retail accounting

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Robert Minnear, manager in the Atlanta office, is well versed in the retail field. A graduate of Ohio State University, he joined the Dayton office of TRB&S in 1953 and transferred to Atlanta when that office was opened in 1958.

Mr. Minnear is currently serving as secretary and member of the Executive Committee of the Altanta Chapter of the Georgia Society of CPAs and is a member of the Board of Governors of the Atlanta Chapter of the Institute of Internal Auditors. He is married and has two daughters.

RETAIL ACCOUNTING is moving forward in new and diverse directions to meet today's needs. The past few years have witnessed impressive developments in computers adaptable to the needs of retailers. New second and third generation computer systems have come within the reach of many more retail organizations. Point-of-sale recorders, on-line-real-time systems and optical scanning devices all loom large on the horizon. But not all of the new developments in retail accounting are confined to electronic data processing. Late in 1962 the Controllers' Congress of the National Retail Merchants Association published the *Retail Accounting Manual.* This book contains new thinking in the areas of expense classification, management reporting, departmental operating statements and branch store accounting.

The purpose of this manual and its predecessors is the development of a uniform accounting system applicable to all retail enterprises. Since such a system must be adaptable to the management information requirements of individual stores, the need for flexibility is paramount. On the other hand, there must be sufficient discipline to insure comparison of results among the various stores using it. The system does not require of the stores uniform policies or procedures. It is not an attempt to standardize the store. The only standardization is in the measurement of the results of store operations.

CONCEPTS RETAIL ACCOUNTING

by Robert E. Minnear

History

The roots of the *Retail Accounting Manual* can be traced back to 1916 when a committee of the NRDGA began a study of expense classification. A series of committees of the Controllers' Congress has studied this topic since then and from time to time reports, books and manuals have been published—*The Classification and Distribution of Expense in Retail Stores*—1917; *A Standard Method of Accounting for Retail Stores*—1922 (revised in 1927, 1932, 1936 and 1950); in 1954 *Standard Expense Center Accounting Manual* (SECAM) and in 1962 the *Retail Accounting Manual.* Each of the manuals has added new concepts to retail accounting but has maintained an evolutionary approach. The 1954 manual introduced the now extensively used concepts of Standard Expense Centers and Production Unit Accounting.

Each manual, however, has remained true to the theme expressed in the original report in 1917:

> "The prime objective is to establish a basis of understanding between stores so that in conversing with one another, or in company statistics of operation, the terms used and the meaning attached to them may be identical to all."

Touche, Ross, Bailey & Smart has been active in this work almost from the beginning. John W. McEachren and J. P. Friedman were members of the 1927 revision committee and Mr. Friedman was a member of the 1950 revision committee. Kenneth P. Mages was a member of the 1954 Standard Expense Center Accounting Manual Committee as well as the committee which prepared the new manual.

Preparation of the new manual was a herculean task covering over three years. The value of time *donated* to writing the manual is estimated at over $400,000. But service to the many divergent businesses of the retail industry necessitated an effort of these proportions. Without the expense manuals of the NRMA, such industry-wide reports as the Harvard Report and the "Merchandising and Operating Reports of Department Stores" (MOR) would not be possible. These invaluable tools provide independent retailers with a wealth of expense and operating statistics to measure their own performance in considerable detail. The growth of the figure exchanges of AMC and similar organizations would hardly have been possible without the standardization provided by the Controllers' Congress manuals.

Multi-Store Accounting

Probably the most significant new concept in the manual is multi-store accounting. We have witnessed in the past decade the phenomenal growth of shopping center department stores which has paralleled the population flight to the suburbs. The large single unit store company which was the model for the development of standard expense center accounting is fast becoming a thing of the past. We have seen the development of so-called "chain within a chain" complexes, e.g., Burdine's seven units in Miami and Maas Brothers' eight units in the Tampa-St. Petersburg area. In past years some large dominant retail organizations seemed reluctant to start branch stores. Today most of these same companies have several units in operation. In early 1959 Rich's in Atlanta consisted of the downtown store and a diminutive twig operation sixteen miles away. Today Rich's has two large shopping center stores and will have a third in operation by the end of 1963. By 1966 Rich's five shopping center stores will circle metropolitan Atlanta.

Growth of multi-store operations demanded modification of the Standard Expense Center Accounting Manual. In fact this need prompted an entirely new manual. The principal accounting problem resulting from these organizational changes is expense distribution. Certain direct or "four-wall" expenses, such as salespersons salaries, can be identified with each selling unit of the complex and should be charged directly to the respective unit's operations. However, many other expenses, for example general management, can not be identified directly with the selling unit. Whether or not to allocate these expenses to selling units and, if so, in what manner were the points in question. In general five methods evolved:

1. Branch stores charged with direct operating expenses only.
2. Branch stores charged with direct operating expenses plus incremental expenses.
3. Branch stores charged with direct operating expenses plus overhead computed as a percentage of sales.
4. Branch stores charged with direct operating expenses plus overhead based on work load.
5. Multi-store approach to expense distribution.

Space does not permit a discussion of each method, but careful reflection will show that each is a refinement of the preceding one. Also each progressive step reflects the increasing importance of the so-called branch stores. For example, when Rich's sole branch was a small appliance store, Method 1 measured in a reasonably satisfactory manner the contribution of that outlet. Virtually no extra effort or expense was imposed on the downtown store to maintain this branch. Such is not the case with the 210,000 square-foot Lenox shopping center store. If Rich's consisted only of a downtown store and one large branch, probably Method 4 would be satisfactory; with the addition of more and more units it becomes extremely cumbersome and almost unworkable.

The multi-store approach seems to be the answer to the problem of expense distribution. Gone is the parent or downtown-branch store philosophy. Now we have a number of selling units and a central organization. The downtown store is now just a selling unit, often the biggest selling unit, but in a few years even this may change.

Under the multi-store method, all expenses which can not be charged directly to a selling unit are collected into the central organization expense pool. The expense center concept has not been abandoned but, in addition to being classified by expense centers and natural divisions, expenses must now be identified as between selling unit and central organization. Many expense centers will have two parts — one for selling unit direct expenses and the other for central organization expense. For instance, under Expense Center 110-Management, Natural Division 09-Traveling, there would be some travel costs charged directly to selling units and others to the central organization. On the other hand some expenses are mutually exclusive. Under Expense Center 110, Natural Division 01-Payroll, the president's salary could only be central expense while the selling unit managers' salaries could only be direct expenses. The chart of accounts in the manual aids in distinguishing between these two new categories of expense.

Controversy still exists as to whether the central organization expense should be distributed to the selling units. One school of thought opposes distribution of central organization expense because methods of allocation are arbitrary and the individual selling unit managers have little or no control over the central organization expense. Others think that for any operating statement of a store to be meaningful, central organization expense must first be distributed to all selling units. Only after developing a final net profit by unit can management make adequate judgments on the stores' operations and compute return on investment. The best approach seems to be a compromise. Allocation of central organization expense should be made, but probably no more often than twice a year. On a month to month or short range basis the most important figure for a selling unit is its contribution, i.e., gross margin less direct operating expenses. But annually or semi-annually a final net profit by unit should be determined.

Chart of Account Revisions

The new manual presents a streamlined chart of accounts. Expense centers and natural divisions have been retained but the old concept of more sophisticated expense center classifications for larger stores has been abandoned.

Older manuals had different charts of accounts for small, medium and large stores. SECAM had account structures for Group A, B, C and D stores, with the number of expense centers ranging from seventeen for the A Group to seventy-one for the D Group. In contrast there are only twenty-three expense centers in the new manual. This reduction in the number of expense centers does not imply that retail accounting has become simpler; rather it recognizes the impact of multi-store operations. Within the multi-store complex there are outlying selling units with streamlined and simplified organizations. It seems undesirable to change the organizational structure of these branches to conform to the more complicated expense center structure of the downtown store. This does not mean, however, that a store can not keep more detailed expense information for any given selling unit or area of expense. The accounts within any of the twenty-three expense centers can be "fanned out" and, for some portions of the larger stores, accounts undoubtedly will approach the detailed D groupings of SECAM.

There was little change in the natural divisions. A new division, fringe benefits, was added and imputed interest was deleted. Equipment rental was revised into a more meaningful division called equipment costs. Total equipment costs may now be collected into one expense center and then prorated out to the users of the services. This latter revision is a recognition of the importance of automation and electronic data processing. To the seventeen natural divisions have been added three contra credit divisions—expense transfers, outside revenues and other credits, and multi-store distribution.

The manual contains and recommends one or more alternate bases for distributing to the selling units the central organization expense charged to each expense center. This distribution of expenses is effected through the multi-store distribution account.

The increasing size and importance of fringe benefits necessitated a revision of the accountability for these expenses. An expense center previously existed for supplementary benefits for the store in total. This center still exists but the new natural division, fringe benefits, provides a means of distributing the total fringe expenses to each division so that they are not buried in expense transfers or some other category.

Another new manual concept is the use of total store sales as the basis for all percentage of sales computations. The prior practice was to express all ratios as a percentage of net *owned* department sales. The difficulty of determining the indirect expenses (real estate costs, credit, etc.) which apply to leased departments was the cogent reason for this change. Elimination of arbitrary allocations of indirect expenses to leased operations should improve comparison of statistics among stores.

Management Reporting

We may point with justifiable pride to the section on management reporting which was written by David Fleisher of the St. Louis Office. This chapter has received enthusiastic response from the retail industry. The techniques and report formats in this chapter were formulated during our survey of the management information system of Rich's. The key elements of the management reporting section are:

1. Elimination of unimportant information.
2. Comparison of actual results with meaningful management standards.
3. Good reporting formats, utilizing trend techniques.

We as accountants are all too familiar with the voluminous reports often prepared for top management. Vital information is either not reported or is obscured by a mass of detail. The busy store executive does not have the time, and should not be expected, to sort out the information he needs for decision making. For example, top management of one of our retail clients received monthly a complete set of the departmental operating statements several hundred pages in length. At our recommendation this was replaced by a two page report highlighting operating statistics by merchandise group and by department.

Too often in retailing the principal standard for comparing current results is last year's performance. The limitations of this performance standard are obvious. The model management reports use planned figures as the measure of performance against actual. Prior year's or month's figures are eliminated from the reports.

A well conceived budgetary and profit planning system is vital to the development of meaningful and useful management reports. The Core concept in developing sound profit plans is flexible budgeting. Under this budgeting philosophy expense behavior is studied and related to different levels of activity. Frequently expense budgets are geared directly to planned sales volume. Although the sales forecast is the first step in preparing the profit plan, the key to constructing flexible budgets is the determination of the most appropriate yardstick for measuring activity for each area being budgeted. Expense behavior is analyzed to determine which costs vary with activity (variable) and which do not (fixed or standby). From this intensive analysis the flexible budget is prepared for each expense center.

The activity unit selected for each expense center will probably be the same as that described in the production unit accounting chapter of the manual. Production unit accounting is not one of the new features of the manual. This technique, which is basically productivity measurement, has been used by some retailers for many years.

Two of the most important considerations in selecting measuring units for production unit accounting and flexible budgeting are:

1. The unit selected must measure the basic activity of the expense center.
2. The production measuring unit must be simple, cohesive, readily understandable, and easy to count, so that collection of data for productivity measurement will not impose an undue burden.[1]

Some examples of measuring units are gross sales transactions for Sales Audit, invoices handled for Accounts Payable, and pieces marked and remarked for Checking and Marking. Typically, retail stores collect considerable data on productivity; therefore, it follows that preparation of flexible budgets should be easier than in many manufacturing operations.

In addition to the two fundamental principles that a measurable unit of activity must be determined and a sound analysis of expense behavior be made, approval of the budget must be obtained from the individual responsible for the expenses budgeted. The latter is basic to any budgeting philosophy but is implicit in the collection of budgeted expenses by responsibility. Standard expense center accounting should provide for the necessary classification of expenses by responsibility.

A sample set of retail management reports was recently developed by David Fleisher for use in one of the Tobe lectures at the Harvard Business School and at the Controllers' Congress Convention in Philadelphia. Since it is not possible to include the model reports with this article, their titles are listed below to provide an idea of the nature and scope of these reports.

Top Management:
- Highlights of Operations
- Total Company Income and Expense Statement
- Total Company Balance Sheet
- Summary of Year to Date Store Operating Results
- Summary of Year to Date Department Operating Results

[1] More sophisticated techniques are advocated by our work measurement specialists. In many cases productivity should be measured by use of a group of weighted units rather than one unit. A full discussion of work measurement is available in our management services libraries.

Store Operations (used only by multi-store companies):
- Income and Expense Statement by Store

Merchandising:
- Group Merchandising Summary
- Divisional Merchandising Summary
- Departmental Merchandising Summary
- Departmental Operating Statement

Operating Expenses:
- Total Company Expense Spending Variance Summary
- Expense Spending Variance Summary by Expense Center
- Expense Center Report

A complete set of these model reports is available in each office in the Retail Services Subject File (File 176.0); a review of them will provide more detailed information about the management reporting system than is contained in the *Retail Accounting Manual.*

Return on Investment

One of the principal functions of the accounting system is to provide information on the profitability of the organization. Management is vitally interested in the profitability of individual segments of the business departments and selling units, as well as the total business. The traditional yardstick is profit expressed as a percentage of sales. Equally important is return on investment which is the measure of efficiency of capital employed. In comparing the efficiency of capital utilization among businesses, complications are introduced because of varying proportions of debt, equity and rented capital. To compensate for this retailers have used for many years a device known as imputed interest. An interest charge, usually 6%, was made against operations based upon capital employed (accounts receivable, inventory and property and equipment). Imputed interest was used to put all stores on a presumably comparable basis. The contra credit to imputed interest was classified as other income, against which the debt equity charge, interest expense, was netted. Of course imputed interest was eliminated in preparing external reports, except for retail figure exchanges.

Many retailers questioned the usefulness of imputed interest and in 1962 the Board of Directors of the Controllers' Congress voted to eliminate its use. Since imputed interest has been dropped from retail accounting little purpose would be served here by a discussion of its shortcomings. Return on investment should provide much more meaningful information on the efficiency of capital utilization.

Since the early part of the last decade much has been written on return on investment. The major problem areas have been defined; techniques have been refined; and substantial agreement has been reached on many controversial areas. However, there is a need to direct research and discussion to specific needs and problems of the retail industry. Agreement must be reached on specifics such as: (1) the basis of measurement—total assets employed or equity, (2) asset valuation adjustments to be made — should lifo inventories be adjusted to fifo, how should asset reserves be handled, how should property and equipment be valued and (3) frequency of computing return on investment.

Once return on investment is computed, it is necessary to evaluate it. Goals and acceptable standards for the industry, businesses and segments of businesses must be established. Because of the free flow of information which prevail in the industry and the reasonable degree of standardization of accounting techniques, valid comparisons of stores should be attainable. It is encouraging to note that at least one major buying group has begun to compile and exchange return on investment statistics. A recent issue of "The Women's Wear Daily" headlined "Rates of Return Stressed as Key Retail Guidepost".

Absolute profit dollars and the rate of earnings on sales are not sufficient information for management to evaluate either the total business or any of its major components. The other part of the return on investment equation, capital turnover (sales divided by capital employed), must receive equal consideration. The management reports presented in the manual provide a section for reporting measures of return. This is but one phase in the overall scheme to provide management with necessary decision-making data.

Other Sections of the Manual

Other chapters of the manual not discussed here are Elements of Reports and Statistics, Departmental Statements, Determination of Gross Margin, Accounting for Workrooms, Production Unit Accounting and Special Explanations. Generally these chapters were brought forward with minor editing from SECAM. The chapter on Special Explanations should be of particular interest to our staff members who are just developing their interests and capabilities in retail accounting. This chapter includes definitions and concise explanations of the method of handling such transactions as repossessions, transfers, leased departments and allocation of central organization expense.

A special chapter has been prepared on the gross margin problems of multi-store companies. Because of the high cost and difficulty of maintaining separate inventory records by store, combined or common stock ledgers are generally used by multi-store organizations. Since separate inventory records are not kept for each department in each store, it is not possible to determine gross margin by department within each store. Under these conditions we have what is called "pooled" gross margin. A single gross margin is derived for each selling department as though the department existed in a single location. It follows then that the overall gross margin percentage for each store differs only because of the varying proportions of departmental sales in each store. Although the use of pooled gross margin and the common stock ledger has made it difficult, if not impossible, to isolate inventory shortages by store and does not produce certain data that was available from separate stocks, most large multi-unit stores believe that the effort and expense of accurately accounting for inventory transactions among the selling units is not justified.

Summary

The close association and identification of our firm with the retail industry and its importance to us should impel us to read and discuss the new manual. Staff members assigned to retail engagements must have a working knowledge of the significant concepts of the manual, particularly the newer ones of multi-store accounting, return on investment and improved management reports. To render proper service to our retail clients we must be prepared to assist them in installing these features in their information system. In some cases we will have to provide the stimulus to interest management in these improvements.

The *Retail Accounting Manual* is not an isolated text on the subject of retail accounting. As we have seen it is the latest product of an evolution which began early in this century. This is certainly not the final word on retail accounting and reporting. Members of our firm have made substantial contributions to this manual and its predecessors. We must have wide understanding and full discussion of the new concepts in retail accounting if we are to continue to contribute to its progress.