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DEPARTMENT STORE ACCOUNTING

by William A. Dillon.

An address delivered at the Eighth Regional Convention of the Midwest District of the American Institute of Accountants at Omaha, Nebraska May 24, 1924.

In view of the fact that your Program Committee has allotted me but forty minutes to cover a subject that the Controllers Congress of the National Dry Goods Association devote days to each year, I have "Boiled down the meat," as was suggested, and will read my notes to prevent digression from the subject and will leave the story telling to those better qualified to move you to laughter.

The subject assigned to me was "Department Store Accounting" but recognizing that this covered too large a field your Committee has suggested that you would probably be most interested in a discussion of the Retail Inventory Method. I have been influenced by this suggestion in the preparation of this paper, but I have also taken the liberty of including a brief outline of the work of the "Controllers Congress" of the National Retail Dry Goods Association further along standardization lines. "The Controllers Group", as you may know is composed of the accountants of those department store affiliated with the National Retail Dry Goods Association. This group is of course responsible to the parent association, but meets independently and confines its discussions to problems of accounting and control. The recommendations and suggestions originating from this body of men have done much to improve accounting practice in department stores generally, and you men as accountants should lend a hand in this work either by way of suggestion to your clients or better; by affiliation with the group. Associate memberships may be had for a very reasonable fee and I believe mutual good would come from this affiliation.

Your Committee's suggestion was well taken as any Profit and Loss Statement depends for its accuracy upon the accuracy of the count and valuation of the Inventory both at the beginning and end of the period under review, and you are as accountants interested in knowing that this new (?) method provides a conservative valuation. It will be my endeavor to convince you that the Retail Inventory Method not only provides conservative and fair valuations but also provides barometers by means of which you may detect fraud or misrepresentation. To bring out the advantages of the Retail Inventory Method it is necessary to touch on the other methods used.

So Called Cost Inventory Method.

Up to a few years ago, a great majority of merchants computed their profits - usually as a total of all departments only - on the basis of an inventory taken at "cost". What an abused word that word "cost" is as it is my personal opinion that not one merchant in one hundred would use the actual price paid in valueing merchandise unless he needed to bolster up his profit showing for the inspection of his banker or other interested.

In a discussion of the relative merits of the so called "Cost" and Retail Inventory Method at the Controllers Congress in Chicago, I asked an ardent defender of the Cost Method if he really priced his merchandise at its purchase price. He was highly insulted and wated to know if I thought him a fool. I then asked him to describe his method of pricing, and he stated that "he put on what he thought it was worth"; as this was in a year of high taxes his reply brought down the house.

One of the most serious objections to the Cost Inventory Method is that it brings about fluctuation in inventory values even though the inventory be conscientiously taken. The conservative merchant attempts to reduce his cost valuation in proportion to the reduction made (or to be made) in the retail prices, and you can readily realize that this can not be accurately accomplished in the limited time available for the average inventory taking.

When the pricing is left to the Department head he is too prone to be influenced by his contractual basis or his desire to make a good showing. I say this without desi e or intent to discredit the average Buyer or Department Head as they are a hard working, conscientious lot but they are also human and are subject to pressure from the "Firm" for volume and profits and it is only natural that they should protect their profit showing; especially as they are usually optimistic in their outlook for next season. They can- they hope- be more conservative next season. Remember also that there are no "book of figures" to check to as there are under the Retail Inventory Method later to be explained. I had one of our buyers say to me just last February, "How is it we never used to have this trouble with shortages under the Cost System" and my answer to him was, of course, "you had nothing to check to". He had a shortage to explain and would have welcomed with open arms, the old hit and miss Cost Inventory System.

Cost of Sales Percentage Method

Some of the more progressive merchants realized at a very early date that such information as they were receiving semi-annually, or in many cases annually, was insufficient to guide them in their judgment of Department Heads, to guide them in day to day decisions or to enable them to recognize a loss before too late. To remedy this condition they had their accountants set up Departmental Records of Operation and to these Records they posted Net Sales and deducted, as Cost of Sales, the percentage of Merchandise Cost shown for the previous corresponding season, or in some instances the average of several such seasons. By subtracting this "Cost of Sales" from the Net Sales of the department they arrived at an estimate of the profits realized.

This plan proved fairly satisfactory as long as price levels remained fairly stationary, but provided no information as to the Initial Mark-Up, Mark-Downs, and Stealing; and, unless these also remained at fairly equal levels or; unless, a gain in one compensated for a loss in another; there was an unexplained difference between the Cost of Sales Percentage used and that shown when actual inventories were taken.

What the progressive merchants wanted was something far and beyond an Inventory System, it was a system of operation that would provide departmentally.

Current information as to

Sales
Purchases
Stocks
Initial Mark-Up
Mark-Downs
Gross Margin
Turn over etc.; and in addition

A basis for inventory valuation that would allocate loss on depreciated merchandise to current season and permit a profit on the sale of the merchandise in the subsequent season; after Mark-Downs and Expense had been provided for.

The Retail Inventory Method is the result of much concentration on this problem.

Retail Inventory Method.
Its advantages and Disadvantages.

Advantages of the Retail System

a. This system was originally adopted because the retail prices presented figures that could be controlled. The retail System is the only system by means of which the true condition of a business can be known monthly without physical inventory each month, and with the minimum of effort. I qualify this for the reason that the executive of a jobbing house can know the true condition of his business by keeping a record of his cost prices. With a department store of any size this would not only be a physical impossibility, but would not present a true picture because of constant price changes.

b. The retail values must always be known in advance of the sale of the merchandise and most of these, for instances, sales and return values, are now being recorded departmentally by all stores.

Under this system it is possible to arrive at an actual inventory at any time, which is particularly valuable from an insurance standpoint. Insurance Companies have made numerous settlements based on inventories determined by this method.

c. Under this method all losses arising from stock depreciations, allowances, mark-downs for special sales, discounts, etc. are recorded against the inventory, and incidentally the profit and loss statement at the time the loss actually occurs. Under the old system these losses were not known until the actual inventory was taken at the end of the semi-annual period, and then the cost figure, if they were actual cost figures, did not provide for depreciation over a subsequent period.

Under the Retail Inventory Plan merchandise is carried forward into any subsequent period at a value that will permit a profit sufficient to cover mark-downs, stock losses, expenses, and the net profit anticipated at the time the merchandise was purchased.

d. Assuming that all price changes are reported and the records accurately kept, the differences between the book and physical inventories represent the merchandise actually stolen. The importance of such knowledge is obvious.

After a year or so of operation it will be possible to determine a percentage figure representative of this loss and the non-reported mark-downs and this percentage can be applied from month to month.

e. Inventory padding by dishonest buyers is a difficult procedure under this method, for if a buyer reports a retail inventory higher than the book inventory this will call for an investigation which will develop the fact that the inventory has been padded.

f. Because of the fact that this system requires a detailed report of all large mark-downs before the merchandise is actually sold, the management can regulate these mark-downs, or at least know the reason for the loss, and can use this knowledge in judgment of the buyer if he or she is to blame.

g. It is not a difficult matter to ascertain the amount which must be applied to the original cost to cover mark-downs, stock shrinkage, alteration charges, freight expenses, and to net the desired profit, but this is only the first step in constructive merchandising, as the merchant must be sure at all times that the initial mark-up is being realized on all purchases. The maintained initial mark-up as determined for the month and accumulatively under the Retail Plan is an exact barometer of this situation. Should the initial mark-up on purchases for any period fall below that required, an investigation will develop from which vendors this merchandise was secured, and with this information at hand, the executive can issue the necessary instructions to his buyer to prevent a recurrence of this condition. In other words, the buyer must buy merchandise that can be sold at the required initial mark-up, otherwise the desired net profit will not be realized.

h. Inasmuch as the book values of the merchandise in each department are available monthly, it is possible to take inventories in varying groups of departments throughout the year, as the physical inventory can be readily checked with the book figures, and such adjustments as are necessary can be made without affecting the results of the departments which have not been inventoried.

It will readily be seen that under this method the management can give more attention to the merchandise in the departments inventoried than would be possible when inventories of the whole store were taken over a period covering but a few days.

i. The Retail Plan permits a discontinuance of placing the cost on the individual items of merchandise which results in a large saving of time and reduces to a minimum the possibility of unauthorized persons learning cost prices.

j. Under this plan it is possible to have available daily, weekly or monthly a comparison of this year's last year's and planned figures. Most stores make weekly comparisons between current and last season, and are satisfied with a comparison of planned figures once each month. The weekly comparison usually covers such items as-

Sales
Mark-Downs
Retail Purchases
Retail Stock
Cost Stock
Merchandise in tr nsit
Uncharged invoices
Unfilled orders, and open to Buy, together with
Accumulative Mark-up percent on purchases
Gross profit percent
Turn-over, and a few of the direct expenses such as
Direct Selling and
Advertising.

Disadvantages of the Retail Plan

Because of the fact that the Retail Inventory method requires the tabulation of all retail prices, it is not practicable where the business is built on special sales, or where retail prices are not stabilized.

A criticism sometimes advanced against the system is the cost of operation, but this is trivial when compared with the actual benefits to be had, and where the merchant thoroughly understands these advantages he does not consider this cost as an expense.

Retail Inventory Method Cont'd.
Its Operation.

One fundamental principal to be kept always in mind, is that it is necessary to keep an accurate record of the Original Retail Price of all merchandise and any deviations therefrom in the way of Price Changes.

When the system is installed it will be necessary to take the Inventory both at Retail and Cost values.

Retail Prices must be entered and extended on each Purchase Invoice.

There are three kinds of Changes in Retail Prices, and these must be recorded in detail on a Price Change Report. These price changes are classified as follows:

1. Additional Mark-ups
2. Mark-downs
3. Mark-down Cancellations.

Additional Mark-ups are transactions where the original retail prices that were placed on the merchandise at the time it was put in stock are advanced or increased to a higher price. Transactions of this kind occur usually under the following conditions;-

1. Discovery is made that merchandise was marked too low at the time it was originally placed in stock and an advance in price is necessary.

2. Due to advance in cost prices by manufacturers or jobbers the retail prices on merchandise in stock at the old cost are advanced to meet the higher retail prices which are necessary on the new lot because of the advanced cost.

Mark-downs are transactions where the retail prices are reduced due to any of the following reasons:

1. Special prices to induce buying.

2. Special prices to dispose of old merchandise odds and ends, depreciated merchandise, soiled or imperfect merchandise, remnants, transfers of merchandise to basement, bargain days and one day sales.

3. Discounts to employees, clergymen, dressmakers or special prices on large sales.

4. Quantity discounts or where an allowance is made at the time of sale because customers buy two or more of the same article.

5. Merchandise given away to customers or charitable organizations.

6. Allowances made to customers because of complaints on merchandise.

7. Reductions in prices to meet competition.

Mark-down Cancellations are, as the name implies, cancellations of mark-downs previously taken. This kind of a transaction occurs usually at the end of a sale where it is deemed desirable to change the prices back on the unsold portion to the prices which existed before the sale was put on.

While both additional mark-ups and mark-down cancellations represent advances in price there is a distinct and important difference between these two transactions that all should thoroughly understand.

An additional mark-up is an advance over the original retail price and fundamentally this advance represents a profit you hope to make sometime in the future, providing the merchandise is sold at the advanced price. These transactions increase your percent of mark-up.

A mark-down cancellation is an advance in price which offsets a loss or mark-down that has been previously reported. It reduces the amount of your mark-down losses but does not in any way affect your gross mark-up percentage.

Transfers of merchandise must be reported and recorded as such both at the Retail and Cost value. The Cost Value should be the Retail Value reduced by the Average Mark-Up Percentage maintained by the Department delivering the merchandise except in the event of joint purchases by Departments when the Original Cost should be used. Original Cost should be used only where the Original Retail Price has not been reduced.

Sales and Returns are usually accumulated departmentally and comment thereon is unnecessary.

While the Retail figures enumerated under this caption are necessary to the Retail Inventory Method they should be entered only on the Statistical Records. It is also unnecessary to enter the Cost Inventories, as computed from month to month, on the General Ledger even in total as these totals can be applied to your General Profit and Loss Statement and to your Balance Sheet without the necessity of making the actual entry. A total sheet should be carried in the Departmental Statistical Record and the amounts shown on this sheet as Sales, Purchases, Freight, Discount and all other items for which there is a Control Account on the "General Books" should be brought into agreement with the Control Account.

Retail Inventory Method.

Formula
The Controllers Congress Have incorporated a "Formula" for the Retail Inventory Method in Volume I of "Standard Method of Accounting for Retail Stores." This is drawn to meet the Government requirements as outlined in T.D. 3058 and further detailed in a letter from Wm M Williams, Commissioner to the National Retail Dry Goods Association under date of Jan. 21, 1921. I have followed this formula in working out the example on the sheets which have been given to you and I ask that you refer to these sheets in order that you may follow my explanation the more easily.

I shall enumerate the processes in the order usually followed.

Col. 2

Line 1	Opening Retail Inventory	90,000.00	+
2	Retail Purchases (including Transfers)	152,000.00	+
4	Additional Mark-Ups	2,000.00	=
5	Inventory Plus additions Retail	244,000.00	

Col. 1

Line 1	Opening Inventory - Cost	54,000.00	+
2	Purchases - Cost	98,800.00	+
3	Freight, Express & Cartage,	920.00	=
5	Inventory, Plus Additions	153,720.00	

Col. 2

Line 5	Inventory, Plus Additions Retail	244,000.00	-
" 1 Line 5	Inventory, Plus Additions Cost	153,720.00	=
" 3 Line 5	Mark-Up	90,280.00	

% of 90,280.00 to 244,000.00 =
" 4 Line 5 Average Mark-Up Percentage 37.00%

Line 10 Calculation of Cost Percentage

a Total Percentage	100.00
b Percentage of Mark-Up	37.00
c Percentage of Cost	63.00

Col 2 Line 6 Net Sales -	100,000.00	+
" 2 " 7 Mark-Downs - Net Include Stock Shrinkage after Physical Inventory	6,000.00	=
" 2 Line 8 Total Retail Reductions	106,000.00	
Col 2 Line 5 Inventory Plus Additions Retail	244,000.00	=
Col 1 Line 8 Total Retail Reductions	106,000.00	=
" 2 Line 9 Retail Inventory End of Period	138,000.00	-
" 2 Line 10 Percentage of Mark Up 37%	51,060.00	=
" 1 " 11 Cost Inventory End of Period	86,940.00	

Retail Inventory Method Cont'd
Formula Cont'd

Col. 1	Line 5 Opening Inventory Plus Additions - Cost	153,720.00	-
Col. 1	Line 11 Cost of Inventory End of Period	86,940.00	=
Col. 1	Line 16 Gross Cost of Mdse Sold	66,780.00	
Col. 2	Line 6 Net Sales	100,000.00	-
Col. 1	Line 16 Gross Cost of Mdse Sold	66,780.00	=
		33,220.00	

Proof:

Col. 4	Line 5 Average Mark-up		37.00%
" 4	Line 7 Mark-Downs	6.00%	
	Less Average Markup 37%	2.22%	
	Cost of Mark-Downs	3.78	3.78%
" 4	Line 14 Gross Margin on Mdse. Sold		33.22%

Standardization Program of the Controllers Congress N.R.D.G.A.

Now just a word about the activities of the Controllers Congress along another line, but one equally interesting to accounts namely; Expense Classification and Distribution.

The Parent association and later the Congress through their Committees have been working toward standard classification and distribution of expense for nearly eight years and little over two years ago they issued a very complete volume on this subject. This volume contains charts and descriptive matter sufficient to enable an average accountant to install the system, but Public Accountants are receiving calls for service in these installations, and I believe you can render valuable aid to your clients in guiding them properly in this work.

The Charts on the wall are reproductions of the charts in this volume and to most of you are self explanatory, but I would like to call your especial attention to their flexibility.

You will note that the Charts are shown in four (4) groups or classes; i.e., "A", "B", "C", and "D", which provide a range sufficient to cover the needs of all stores, from the smallest to the largest. All the merchant is required to do is to select the chart which will give him the information required, and as his business increases and it becomes necessary for him to have a further classification of expense, he can adopt one of the other charts, showing a greater sub-division of the basic accounts. Inasmuch as the accounts shown in each classification from (A" to "D" are simply a sub-division of the accounts in the chart immediately preceding it, this expansion can be made without destroying the possibility of comparison with the accounts as maintained in previous years.

If his expenses are classified in accordance with the recommendations of the National Association, he will then be able to share in the benefits to be derived from a comparison of Service Costs, with others classifying their expenses in a similar manner.

Too many merchants regard the effort necessary to obtain a fair classification, as unnecessary detail, and depend upon a visual check as their guide in the regulation of expense. This may be advisable for the very small store, but the executive of the average store is too busy to maintain this physical contact. There is nothing that will force a realization of an unbalanced organization as well as the cold figures representing the cost of operation, and shown in their relation to sales.

RETAIL INVENTORY METHOD - Formula

The Government's Requirements are met by the following formulas

	(1). Cost	(2) Retail	(3) Mark-Up	(4) % of Mark-Up
1. Opening Inventory (Lines 9 & 10 preceding period)	54000	90000	36000	40%
2. Purchases	98800	[illegible]2000	53200	35%
3. Freight, Express & Cartage, Inward	920	xxx	xxx	xx
4. Additional Mark-Ups, Less additional Mark-Up Cancellation	xxx	2000	xxx	xx
5. Total of Inventory, Plus Additions	153720	244000	90280	37%
6. Net Sales	xxx	100000	xxx	xx
7. Mark-Downs, less Mark-Down Cancellations	xxx	6000	xxx	(R) 6% (c) 3.78
8. Total Retail Deduction (Sum of items 6 & 7		106000	xxx	xx
9. Resultant Retail Inv (Retail Inv.) on line 5, column 2, minus item 8	xxx	138000	xxx	xx

10. Calculation of Cost Percentage:

(a) Total Percentage	100%
(b) Percentage of M.U. (line 5, col.4)	37%
(c) Percentage of Cost (a minus b)	63%

	(1) Cost	(2) Retail	(3) Mark-Up	(4) % of Mark-Up
11. Cost of Inv. (item 10 (c) applied to item 9	86940	xxx	xxx	xx
12. Resultant Mark-Up and percentage (item 9 minus item 11)	xxx	xxx	51060	
13. Gross Cost of Merchandise Sold (difference between Cost Inventories on lines 5 & 11)	66780	xxx	xxx	xx
14. Gross Margin on Mdse Sold difference between	33220	xxx	xxx	33.22
15. Net Sales on line 6, col 2 and	xxx	100000	xxx	100
16. Gross Cost of Merchandise Sold on line 13 col. 1	66780	xxx	xxx	66.78

Proof: Average Mark-Up (line 5 Col 4)	37%
Less% Cost of Mark-Downs (line 7 col.4)	3.78
Percentage of Gross Margin (line 14, col.4)	33.22