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Distribution Costs—A New Frontier for Accounting

BY DONALD R. LONGMAN

THE GREAT new frontier for accounting lies in accounting for distribution costs. This field requires, however, not only an understanding of the principles of accounting but also an appreciation of the range of activities carried on for the purpose of marketing goods and services. In our era of specialization it has seemed peculiarly difficult for the separate departments to coöperate in such detail that the sales department becomes aware of the potentialities of accounting as a tool to scientific sales management and the accounting department becomes fully cognizant of the needs on the part of distribution men which it could fill.

The need for greater coöperation has become increasingly acute. Surveys of distribution have shown it to absorb a tremendous proportion of our total income. Already these costs far exceed the costs of manufacturing in the United States,[1] and charges of waste and inefficiency are leveled at marketing agencies from all sides. It is impossible to refute such charges when our means of distribution cost control are so obviously inadequate for location and measurement of existing wastes.

Passage of the Robinson-Patman act in June, 1936, made the general need for better accounting data for sales operations more immediately pressing. It is illegal to offer differences in price to different customers under this act unless the seller can affirmatively show the price differentials to be justified by variations in the cost of serving them. Such evidence can rarely be offered with the accounting now generally available. The alternatives of uniform prices or fear of prosecution are not pleasant.

Despite these facts, however, there seems to have been little constructive action taken by the accounting fraternity to provide such cost information. Marketing men look upon the origination and institution of accounting systems as the accountant's problem. So it is. Nonetheless, the accountants can truthfully say that there has been no real attempt on the part of sales management to point out specifically to them the objectives they desire from accounting. No one can intelligently prepare techniques to attain an undefined goal. It is the object of this article to define that goal, to show what information is wanted and needed for completely efficient marketing which only the accountant can provide.

Scientific sales management requires from the accountant statements showing just what it costs to sell the several different products of a line. Distributors [2] now have only a knowledge of the total cost of selling all their products.

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[1] A committee of the Twentieth Century Fund after exhaustive investigation concluded that even in prosperous 1929 no less than 59 per cent of the consumer's dollar was spent on transferring the finished product to the consumer's hands. (*Does Distribution Cost Too Much?* Paul W. Stewart and J. Frederick Dewhurst, Twentieth Century Fund, 1939, p. 117.)

[2] The term "distributors" in this article is meant to include all agencies engaged in the work of marketing goods and services. It includes manufacturers, wholesalers, selling agents, and other functional middlemen, and retailers. Similarly, the term "sales management" is meant to include the work of formulating, instituting, and supervising the operation of sales policies for all kinds of distributors. Various marketing institutions are employed as examples in the course of the article simply to indicate the scope of the applicability of the accounting goals.

It is true that accounting statements tell them the cost of salesmen's salaries, of traveling expenses, of advertising, and so on; but these are totals for the business as a whole. There is no reason to believe that each article has an equal cost in dollars or an equal cost in percentage of sales. Any practical businessman knows that it takes more advertising, more promotion, more freight, more warehouse expense for some articles than for others, but he cannot tell how much more. And until he can, he has no knowledge as to whether he has made or lost money (and how much) on any single product of his line. Of what value is it to know the total cost of advertising or of freight, when it is impossible to know whether these expenses have contributed in some fashion to the company profit? In fact, some articles may cost more to sell than they bring in revenue. When this is so, one can derive little satisfaction from seeing that total advertising or freight costs are no greater in dollars or in per cent of sales than they were at some previous time or among other similar companies. Would it not be wiser to try to find the unprofitable products, find why they are unprofitable, and either adjust marketing methods for them or eliminate them from the line if they are not absolutely necessary to the maintenance of a profitable volume for other products?

It is the accountant's job to present the information. The sales manager is poorly placed to separate the products sold at a loss from those which are profitable. And the accountant must render a profit-and-loss statement in detail for each product. Then the sales manager may judge the reason underlying the loss or profit and use his information to render loss products profitable and increase the profits of others. He may go further, too, and group his products by departments, by brands, or by price lines, and learn much about the factors which seem to contribute to produce loss or gain. He can compare advertised with unadvertised articles. He might even compare profits on articles differing in style or design, in size, in quality, or in any other characteristic, so that buying or production planning may be more intelligent and inventory control more certain of bringing satisfactory results.

Profit-and-loss statements by products offer the distributor a scientific tool more valuable than all others at his command. Classification and reclassification of the statements for individual products by gross margin, by source of supply, or by any of a great variety of methods offer the nearest possible approximation to laboratory testing available to sales managers. Differences in profit as between different classes of products cannot be positively ascribed to the difference which is the basis for the separate classification. Nonetheless, if the products compared are at least reasonably similar in all other respects, it is very likely that the difference leading to separate classification is responsible for the divergent profit showings.

If the profits on one line of products, for example, are substantially less in per cent of sales than the profits on some other line or lines, the likelihood exists that the difference in profit is the fault of the product line. But it is only a likelihood. Not until the comparison is made with other lines which have approximately the same mark-up, which are given approximately equal promotion, and which are similar in every other significant respect, that one can definitely attribute a difference in percentage of profit to the line itself.

The product is but one of many variable factors bearing upon marketing costs and upon profit and loss. Customers differ in frequency and size of order, in speed of payment, in distance from the shipping point, and in many other respects. Such differences necessarily mean that the cost of selling to

one must vary from the cost of selling to another. At present it is exceptional for any company to be able to say with reasonable confidence that Customer X is profitable and Customer Y is not. It is the accountant's task to make clear the variations in cost attributable to different customers or customer types. He must say that these are the costs, as well as can be estimated, of selling X as opposed to selling Y. Only then can the sales manager intelligently formulate plans to convert customers who are unprofitable into sources of future gain. He cannot do so until he *knows* which are unprofitable, and he cannot intelligently plan until he can see how his money was spent. Then he finds a hundred ways suggested in the profit-and-loss statement by which he may retain that customer's trade yet make him contribute to the total profit — not on every sale, perhaps, but on the majority of them, so that at the end of the year some part of the seller's net gain can be attributed to the sales to Customer Y.

The statements for individual customers, too, may be added together to permit comparison of customer types. The total profit from customers in one territory may be compared with the profit from customers in another. The profit showing of different channels of distribution can be found. Classification may be extended to comparison of customers of different size, of different credit rating, or to customer groups differing in any possibly significant respect. If such classification is carefully made, if the customers included in the comparison are as similar as possible in every respect except one—the basis of classification—the results may be accepted with confidence as indicating the significance of the variable factor upon profit.

It is impossible to overlook the fact that comparisons of profit alone are inadequate to the formulation of improved distribution policies. Profits are but the remainder after expense is subtracted from income. Only after detailed study has been given the differences in expense percentages does it become clear how the variable factor caused the variation in profits. Such study provides the basis for alterations in sales policy.

The distributor should have even more information that only the accountant can provide. Everyone concedes that small orders constitute a major drain on profits, but few can tell for their own businesses just where the line between profitable and unprofitable order sizes can be drawn. The sales manager needs reliable data to show which expenses vary with order sizes and which do not, and he wants a picture of the extent of variation. He can see then which expenses are out of line when orders are small, and by directing his attention to them he may find many ways of reducing small-order costs without loss of customer goodwill. No distributor wishes to refuse orders small or large, but he does insist that there be no indiscriminate acceptance of orders which can only be filled at a loss. The knowledge of cost and profit by order size permits him to protect himself by establishing a suitable discount structure to replace the guesswork he has today.

A plague to marketing in recent years has been the extensive competition in offering services of every sort. These are usually added piecemeal as concessions to a few customers to obtain their orders. They soon become part of the business routine, and as salesmen encounter difficulties in completing transactions, the services are offered more freely until they are available to all as a matter of course. Often the distributor wonders whether their cost does not far exceed their worth. He may judge with some accuracy, at least through market research, what each service is worth in sales; but as yet the accountant rarely has told him its

total direct and indirect cost. Such information is badly needed.

When accountancy has provided these statements for sales management, it will have rendered a most valuable service. It will have provided for the first time a sound basis in costs for sales policy. But it will not yet have exhausted its possibilities of making distribution more efficient.

Assume that the Z Company has developed a wholly satisfactory detailed system of determining the profitability of products, of customers, of territories, of units of sale, and so on. Assume further that it has employed these as bases for major adjustments in marketing policies. It may still show less profit than it could and should. Indeed, it is entirely possible that without additional refinements involving the establishment of standard costs the results of the accountant's work may have been misleading, may have led to changes that ought not to have been made.

The profit-and-loss statements by products represent only an allocation of *actual* costs and a statement of *actual* profit or loss. It does not follow that the existence of an actual loss shows the necessity for a change in marketing policy. Other operating factors affect cost and profit no less than does policy; and until it is clear that the marketing operations have been carried out efficiently, it is unwise to alter policies simply because certain products, customers, or units of sale show an actual net loss.

For example, inefficiency on the part of order fillers, packers, or delivery men may lead to abnormally high actual labor costs. When these costs have been allocated to customers, products, and so on, it is obvious that they will appear less profitable than they should. The difficulty with the use of such profit-and-loss statements arises out of the fact that they are constructed from *actual* rather than *standard* costs. There could be no question concerning the employment of commodity and customer statements as a basis for formulating policies if they presented a picture of the profit and loss which would exist if all operating details were carried out efficiently. Only then would the statements measure policies exclusively.

Labor inefficiency is by no means the only factor destroying the validity of profit-and-loss statements as measures of policy. If there were any idle equipment or space in the stores, warehouses, or other buildings, distribution of the cost of maintaining it to territories or units of sale would necessarily affect their profit showing. One could not estimate the true contribution of each territory or unit of sale until the effect of the idle equipment and space had been eliminated from the statements.

In the same fashion, the operating routines or techniques (as distinct from the efficiency of labor in carrying out the routines) influence the actual cost of marketing in total and as between products, territories, channels, and so on. And, finally, the degree of financial strength or purchasing power may make a great deal of difference in the cost data.

It is, therefore, up to the accountant, if he is to make his full contribution to the improvement of marketing efficiency, to separate the influences upon cost of (1) policies (commodities, customers, etc.), (2) labor efficiency, (3) plant utilization, (4) operating routines, and (5) financial strength or purchasing power. Each of these five factors must be measured separately, and the measurement of their effect upon cost should be in terms of dollars. Only *standard* costs of distribution, costs which would exist if labor were completely efficient, if the plant were fully utilized, if the routines were the best possible for the job to be done, and if the company employed its purchasing power to its best advantage, may be

allocated to products, customers, and so on. Only when it becomes clear that even under conditions of standard operating efficiency, certain products or customers are unprofitable or less profitable than they could be, is management really justified in altering its sales policies or in eliminating the customers or units of sale showing the loss.

While such profit-and-loss statements are particularly needed by sales managers, the separate measures of the influence upon cost of labor efficiency, plant utilization, and so on would be extremely valuable. The standard costs of performing each separate function and the standard costs for specific goods and services employed in each function should be compared with similar standards for other companies in the industry to bring out the degree to which the company routines are efficient and the financial strength both adequate and properly employed. Comparison of the same company standard costs (by functions) with actual costs brings out the deviation in cost ascribable to labor inefficiency or incomplete use of space and equipment. A detailed analysis of standard and actual costs would make possible separate measurement of the effects of labor efficiency and plant use.

When these studies have been made and when they have been subjected to careful analysis by the executive officers of the company, it will be clear just how efficient the labor force has been, how expensive the idle plant and equipment, how significant the company purchasing power, and how effective the routines and techniques in use. The statements can be prepared in minute detail so that the precise points of deviation between actual and standard costs, and between standard costs for one company and those of others in its field will be entirely clear. Suggestions for waste reduction lie implicit in these figures. Similarly, the statements of profit and loss by products, by customers, by units of sale, by territories, by channels of distribution, and by lines of product, when prepared with standard costs and presented in full detail, suggest in themselves adjustments which can increase the company profit.

It is through such data alone that we can trace and eliminate all those small wastes which exist in even the best managed concerns. For, as Castenholz has said, ". . . net losses are usually the resultant of losses in some directions that exceed profits in other directions. By the same token . . . net profits result from certain profitable operations under certain sets of conditions that exceed losses ensuing from other sets of conditions. And, finally, . . . even profitable unit operations may contain loss elements which can often be eliminated." [3]

But the usefulness of the detailed cost statements extends to still other phases of operation. Detailed standard costs taken in conjunction with market research work and promotional plans make possible the establishment of a more satisfactory financial budget system. Pricing should be more intelligent, based on specific facts relating to the market and to the cost structure. Conformity with the Robinson-Patman act would still permit the efficient distributor to give full differentials in cost to customers whose method of buying, unit of purchase, or manner of receiving or paying for merchandise make savings possible. It is important to many concerns that they be able to give such concessions to large buyers within the limits of the law. Finally, one may expect the greater knowledge of the structure of costs to lead ultimately to an orderly system of marketing to replace the chaotic conditions which have existed in so many fields in recent years.

Obviously the accountant who sets forth to develop a system of accounting

[3] *The Control of Distribution Costs and Sales*, W. B. Castenholz, Harpers, 1930, p. 47.

or to adapt a current system to trace and measure the wastes in marketing in this manner faces a formidable task. He must study the process of distribution in detail and classify the major possible sources of waste and loss. He must find ways to determine standard costs and compare them with actual. He must have his accounts so established that variances between actual and standard cost are subject to the least possible doubt as to their cause. He must develop methods of allocating costs to products and customers with the maximum possible accuracy. And he must understand clearly just how strong and how weak his standards and allocations are, so that interpretation of the statements he renders may be wholly sound.

This is a huge order indeed. The results to be obtained, however, are so significant, so essential to the advancement of efficient marketing that they will repay most companies many times the cost of developing, adapting, or instituting the necessary techniques. Recollection of the development of manufacturing cost accounting reinforces the belief that however difficult the task may seem, the accounting fraternity will evolve techniques entirely suitable to achieve the aims set forth here. The present problems are less difficult by virtue of the experience already gained by those who have contributed to the establishment of effective systems of production accounting; and the almost universal adoption of these systems bears witness to their value.

If the accountant will only seek the coöperation of the sales department, if he will only attempt to forget the details of present accounting routine to absorb himself in the operations of the marketing division, it will not take long to become acquainted with the nature of the problem of accounting for distribution costs. This step seems to be one of the most difficult; but, once taken, it opens the way to constructive effort in evolving necessary techniques. Highly successful beginnings have already been made by the H. S. Dennison Company, by the National Wholesale Druggists Association, by the Department of Commerce, and various other companies and agencies. And it is generally true, in accounting as elsewhere, that it is the beginning which is hardest.