DEPARTMENT OF BUSINESS MANAGEMENT

Conducted by Paul C. Olsen.*

COMMENTS, QUESTIONS AND SUGGESTIONS ARE INVITED AND WELCOME.

Readers are invited to submit comments, criticisms and suggestions regarding the material which appears in this department. The Editor also will undertake to answer questions regarding general problems of business management. Letters of general interest will be published, but the writer's name will not be revealed without his permission.

THE CHANGING EMPHASIS IN THE STUDY OF DISTRIBUTION COSTS.

BY PAUL C. OLSEN.

In 1922 a joint committee of the United States Senate and House of Representatives, officially titled the United States Congress Joint Commission of Agricultural Inquiry, made a monumental report. Overcoming difficulties which in the beginning seemed insuperable, the Commission collected facts which permitted the calculation of distribution costs for many important agricultural commodities. In addition, it calculated the share of these costs which were incurred by the producers themselves, the various wholesale distributors involved and the retail outlets through which these commodities finally reached the consumer.

When these studies revealed that one-half to two-thirds the price the ultimate consumer paid for important products of the farm and orchard was a payment for distribution costs, the popular opinion of the extortionate and unconscionable profits of the "middleman" seemed to be confirmed. Popular opinion always has inclined to the idea that when a retailer buys an article for sixty cents and sells it for a dollar, he has made forty cents clear profit.

Incidentally, it is betraying no secret to say that there were and are thousands of retail and wholesale distributors who hold the same opinion. What kind Santa Claus or other good fairy pays the rent and other costs incident to the conduct of these wholesale and retail businesses, I am unable to say.

One great value of this report of the Congressional Joint Committee, therefore, was its revelation to consumers and distributors alike that the tremendous spread between the price producers received for agricultural products and the prices ultimately paid by consumers was not caused by extortionate profits obtained by wholesale and retail distributors, but rather by the costs of admittedly necessary distributive activities. Freight, for instance, and the costs of refrigeration and storage. In fact, this Congressional survey revealed that the total of all the profits obtained by wholesale and retail distributors was so small that their entire elimination would have little or no effect on the price paid by the ultimate consumer. (Admittedly there are wastes and inefficiencies in the distribution of almost any product, but competitive conditions in distribution are such as not to permit, for long, extraordinary and unusual profits. In fact, competitive conditions tend even to enforce a considerable degree of distributive efficiency in order to permit any profits at all.)

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This Congressional investigation in 1922 was not the first wide-spread effort to get the facts on distributive costs. As far back as 1913, the Harvard University Bureau of Business Research undertook to collect these figures in so far as they applied to retail shoe stores. The first difficulty met was that an amazingly large number of shoe retailers kept no books at all or kept them in such a careless or illogical way that their records were of little or no value. A real contribution was made, therefore, when the Bureau devised an up-to-date and easily used system of operating accounts designed especially for retail shoe stores. It was not until 1919, however, that a sufficient number of shoe retailers had adopted this simplified accounting plan to permit a report to be made on their distribution costs. This is an illustration of the difficulties and delays incident to the progress of such a pioneer movement.

Results, however, were obtained more quickly with retail grocers. A report was issued early in 1915 of the typical or usual costs incurred by retail grocers during 1914. Since its pioneer efforts, the Harvard University Bureau of Business Research has published similar reports on the usual distributive costs incurred by manufacturers, wholesalers and retailers in seventeen different lines of business.

In addition, similar investigations have been made in these and other lines by other university bureaus of business research, trade associations and independent research organizations.

The value of all these studies is that they create a standard based on actual facts to which an individual operator can compare his own results. Before facts of this kind were collected and published, a shoe retailer, for instance, with wages of his sales force amounting to 14 per cent of sales had no idea whether or not this was a good or a poor showing. If the usual result reported by a hundred or more stores operating under conditions like his is 11 per cent, this certainly is evidence enough to warrant a serious inquiry as to why his costs for this particular item should be more than 25 per cent greater than the average amount paid by others facing similar conditions.

This is, of course, but one illustration of many which might be cited of the practical value of the creation of a standard to which an individual can compare his own distribution costs. There are, in addition, many other values which can be attributed to the collection of these facts.

One of the most important of these is the increased appreciation on the part of progressive business men—particularly retailers—of the necessity of accurate and up-to-date records. (Typical costs in a particular line of business are of no practical value to the individuals in it unless they have records of their own with which to compare the averages.)

Thus the old idea that an article bought for sixty cents and sold for a dollar produced forty cents clear profit has been gradually disappearing. Stated in accounting terms, there has come in recent years an increasing understanding and appreciation of the difference between gross and net profit.

One result of this growing understanding of the costs of doing business has been a demand upon manufacturers by wholesalers and retailers for discounts commensurate with the average costs shown by these recently revealed facts. For instance, retail druggists have argued that with costs in their stores averaging

28 per cent of sales, it is manifestly impossible for them to make even a small profit with a discount of less than $33^1/_3$ per cent of sales. In almost every line, manufacturers have been quick to accept this line of reasoning; consequently, in recent years, there have been marked upward tendencies in the discounts allowed wholesalers and retailers, particularly on standard merchandise.

Theoretically, the idea is sound. If a distributor obtains a gross margin on each and every item he carries which is larger than his average cost of doing business, his whole business is bound to be profitable because each and every sale is made at a profit. An obvious corollary to this hypothesis is that the larger the gross margin the greater the net profit from the sale of a particular item.

This is a beautifully constructed theory, but along came a group of shrewd merchandisers to upset it. The short line jobber is a familiar figure in groceries, drugs, hardware and tobacco. Coöperative buying associations owned by retailers are another type of wholesale outlet which follow the same policy. They sell a comparatively small number of the largest and fastest selling items at very low prices. For instance, a common practice of the short line jobber or the coöperative association in the drug trade is to rebate to retailers 10 per cent of the $16^2/_3$ per cent discount which is customarily received from manufacturers.

Average costs of doing business in the old line wholesale drug houses run from 15 to 16 per cent of sales. The wholesaler schooled in this theory immediately makes two claims. One is that he cannot afford to give away 10 per cent of his $16^2/_3$ per cent gross margin because his costs of doing business are 15 to 16 per cent of sales. The second is that those houses which do will soon find themselves in the sheriff's hands.

As everyone knows, these predictions of the early demise of the short line jobber, coöperative wholesaler and other cut price distributors have been vain. In fact, some of the conservative old line houses have had to follow the same policy in self-defense, but not without considerable misgivings. Strangely enough, they, too, are still doing business and in many cases making more money than ever. But more of that later.

In retailing, a similar situation has been precipitated by shrewd and far-sighted merchants. The cut price policies of the chain stores, mail order houses and department stores are the most familiar examples.

"How do they do it," inquires the anxious retailer. "My costs are 25 per cent of sales. How can I meet their prices when they are selling merchandise on a gross margin of 20 per cent?" Again come the familiar predictions of bankruptcy for the cut price merchants. Year after year, however, the price cutters go serenely on with amazing success.

The explanations were that the cut price items are merely loss leaders. With increasing price consciousness on the part of consumers and an enormous proportion of their business in the so-called cut price items, it appears as if the price cutters soon would be forced out of business if these items really are sold at a loss. What are the facts to support this assertion?

When our anxious retailer friend says his operating costs are 25 per cent of sales, he means that at the end of a year's business the total of all the expenses paid out during the year amounted to just 25 per cent of the total amount of the sales he made during the year. That is to say, the average cost of doing business was 25 per cent of sales. Quite obviously, some sales were made, perhaps, at a cost much less than 25 per cent while others, unfortunately, were made at costs much greater than 25 per cent. All this merchant knows is that the average of all of them is 25 per cent.

If he knew the costs of carrying and selling individual items of merchandise in his stock instead of merely the average cost for all of them, he would gain two important advantages. Since it is a physical impossibility for him to give equal attention to all the items in his stock, he would know, then, definitely, the items in his stock which are sold most profitably and therefore the items on which he could concentrate selling effort most profitably.

Second, on items in which price competition proved to be keen, he would know definitely the extent to which he could reduce prices and still sell them at prices which, at least, did not produce a loss.

In the course of an investigation of the costs of carrying and selling individual items of merchandise, I had the good fortune to discuss these propositions with Dr. Paul H. Nystrom of Columbia University. Dr. Nystrom recounted the philosophy of a boyhood employer of his who conducted a general store in the middle west.

This merchant evidently was wise beyond his time. Canned vegetables in those days, as they do to-day, carry larger gross margins than most grocery store products. On the other hand, sugar is handled on perhaps the narrowest margin of all grocery store merchandise. While this merchant's competitors fought with each other to capture the canned goods trade of the community, he concentrated upon its sugar business. He wisely saw that gross margins and even net profits per unit sale are not the only determinants of the total net profits earned in a business. The volume of business done or possible to do in an item and the rate of turnover are also vital determinants of total net profits.

For instance, few vegetable hucksters grow rich even though the gross and net margins of profit are high and daily turnovers of merchandise stock are obtained; the volume of business that an individual huckster can do is too small. Similarly, a drug store with an annual volume of $2,000,000 would be considered an unusually large store. If, however, it had to maintain a stock of merchandise valued at $1,500,000 in order to do this business, the store would not be considered a successful one even if it earned a net profit amounting to 8 per cent of sales. The return on the investment in merchandise would be unattractive.

Recent investigations by the United States Department of Commerce and other responsible agencies definitely confirm the shrewd intuitive judgments of the far-sighted middle western storekeeper whose ideas I have quoted. An investigation in a wholesale grocery house showed distribution costs for different classes of commodities varying from 6 to 16 per cent of sales although the average for the entire house was 10 per cent. In the distribution of hardware and of paint and varnish, similar facts have been brought to light.

The National Wholesale Druggists' Association has found astonishing variations in costs and profits in different lines. In the retail drug trade, the Druggists' Research Bureau examined more than 177,000 individual retail sales. It found stores in which 2 per cent of the merchandise stock on hand accounted for 8 per cent of the sales and 16 per cent of the total net profits.

It is interesting and profitable to a business man to know that these variations in distribution costs for individual items exist and of even greater interest and profit to know the extent of the variations. One further characteristic is worth considerable note because it answers the frequent statement that merchandise sold at cut prices is bait merchandise and composed primarily of loss leaders.

In all of the investigations so far made, the conclusion is that the most profitable items are those which are sold in large volume and in which, therefore, it is easy to obtain a rapid turnover. Gross margins and even net profits per item are usually less for this class of merchandise, but the much larger volume of sales and the rapid turnover prove to be more than sufficient to overcome this disadvantage. The merchandise which is chosen for selling at cut prices is, of course, merchandise of wide appeal and, therefore, merchandise which can be sold in large volume with rapid turnover.

The many valuable investigations which have been made of average costs of doing business in various manufacturing, wholesale and retail lines have contributed greatly to an understanding of what distribution costs are and the totals they reach in various kinds of businesses. The organizations which have sponsored these studies would be the last to urge, however, that their results constitute the end of the road.

Calculation of distribution costs on individual items occupies a position in relation to these general studies of distribution costs analogous to that of production cost accounting and general accounting. With distribution costs to-day composing the largest single item in the price consumers pay for merchandise, the reason for the steadily increasing interest in individual distribution costs is clearly evident.

A FEW OF MANY HISTORIC AND INTERESTING PLACES OF BALTIMORE, THE A. PH. A. CONVENTION CITY.

The points following are within four blocks or less of Washington Monument, the first monument erected to the "Father of Our Country," located at Charles and Monument Streets. In the immediate vicinity of the monument are:

The Peabody Institute, school of music, art, library, statuary and paintings—Monument and Charles Streets. Statues of George Peabody—Mt. Vernon Place; Chief Justice Roger Brooke Taney, General John Eager Howard—Washington Square (Charles Street and Madison); Severn Teackle Wallis—Washington Square near Center Street. Mt. Vernon M. E. Church—Northeast corner Monument and Charles Street (Mt. Vernon Place). Attached to the wall of this building is a tablet bearing the following inscription: "Francis Scott Key, author of 'The Star-Spangled Banner,' departed this life on the site of this building, January 11, 1843." Walters Art Gallery—The finest private art collection in America—Northwest corner Charles and Centre Streets. Roman Catholic Cathedral—Cathedral and Mulberry Streets. The late Cardinal Gibbon's residence—Charles and Mulberry Streets.

Other locations will be referred to in succeeding issues of the JOURNAL.

NOTICE FROM TRANSPORTATION COMMITTEE.

After several months of negotiations, we have just received notice that reduced fares to the Baltimore meeting will be allowed on the certificate plan, with a smaller number of required certificates than in the past, and the time for beginning the return journey on the reduced rate tickets has been extended through May 17th, to allow members to attend the United States Pharmacopœial Convention. Further details will be given later.

THEODORE J. BRADLEY, *Chairman.*