WHITE PAPER

ENHANCE MERCHANDISING EFFECTIVENESS THROUGH RETAIL TO COST ACCOUNTING TRANSFORMATION

Abstract

In making the right accounting choice – whether retail or cost – retailers must assess the merits and demerits of different methods of accounting. They also need to factor in certain key aspects and hurdles that they may face while transitioning to a different method of accounting. In this paper, we will explore the benefits of the cost method of accounting over retail accounting, key factors to consider while transitioning to a different method of accounting, and the challenges that retailers should be prepared for while making the transition from retail to cost accounting.

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Retail vs Cost Accounting

Traditionally, retailers have been using the retail method of accounting due to challenges in accurately maintaining the cost of individual SKUs on an ongoing basis. Retail accounting enables convenient and quick estimation of cost of inventory by expressing its retail value in terms of cost-to-retail percentage, also known as cumulative mark-on percentage. However, retail accounting provides profitability level insights only at an aggregate merchandising hierarchy level. At best it provides an estimate of profitability, which may vary significantly across items within the same department. Cost accounting, on the other hand, utilizes item cost-to-value inventory, enabling a more accurate calculation of inventory valuation and profitability, and allows business processes and metrics to be aligned with item cost and profitability.

One of the challenges with deriving inventory valuations in retail accounting is that cumulative mark-on percentage is retrospective in nature and may not correctly represent inventory valuation for locations with high churn of ever-changing merchandise mix. This makes tracking item-level profitability and measuring supplier performance a challenging task for merchants. Marked improvements in merchandizing and inventory system capabilities have now made it feasible to accurately capture item-level cost. With improved system capabilities and other advantages, retailers are now increasingly keen on a transition to cost accounting.

With all its advantages, transitioning from retail to cost accounting is nonetheless a major transformation. In this accounting transition journey, there are some key aspects that must be considered with care to successfully navigate this journey.

Retail Method of Accounting	Cost Method of Accounting
Provides an estimate of inventory valuation	Enables precise calculation of inventory valuation
Provides an obscured view of margins at an aggregated (dept/class/sub-class) level	Improves visibility of item-level profitability
Lacks visibility of item-level profitability to alter sell-through and adjust merchandize mix	Helps improve product sell-through and velocity through precise capturing of item cost
Provides imprecise inventory valuation due to retrospective nature of cumulative mark-up	Enables enterprise-wide alignment of processes and metrics with item-level cost and profitability

Table 1 – Comparison between retail and cost accounting

Evaluating Business and Financial Impact

Maintaining business continuity is a critical aspect when moving to a new accounting methodology. To enable a smooth transition, it is important to accurately assess the impact on financial and accounting metrics while recalibrating processes and systems to align with cost accounting. Transitioning from retail to cost accounting can result in changes to inventory valuation and how the ending inventory is calculated. For example, markdowns and markups impact inventory valuation in retail accounting as they affect retail value, but it is not so in cost accounting. Moreover, certain types of locations such as quality centers may carry merchandize with zero retail but may have costs associated with them, which can alter how the inventory gets valued in different methods of accounting.

Transitioning to a different method of accounting may affect not just metrics such as cost of goods sold (COGS), inventory shrink, and beginning/ending inventory values, but it can also alter the treatment of different types of transactions in inventory and ledger calculations. For example, in cost accounting, weighted average cost is calculated differently depending on the inventory available in different scenarios involving shipments, receipts, and stock adjustments. It is therefore essential for business teams to fully comprehend the treatment of different types of transactions in different methods of accounting and their impact on inventory valuation before switching to a new method of accounting.

Metric	Retail Accounting	Cost Accounting
Cost of Goods Sold (COGS)	**Approximation,** based on cumulative mark-up percentage for a period/group of items	**Calculated,** based on item-level weighted average cost (WAC) at the time of sale
Sales	Net Sales	Net Sales
Transfer Cost for moving goods	**Estimated,** based on transfer costing of inventory through markdowns	**Accurate,** real-time calculated for receiving locations, based on Cost in sending location
Cost of Goods Sold (COGS)	**Approximation,** based on cumulative mark-up percentage for a period/group of items	**Calculated,** based on item-level weighted average cost (WAC) at the time of sale
Current Inventory valuation	**Approximation,** based on the ending inventory at retail * the cost component (1-cumulative markup %)	**Calculated,** sum of the weighted average cost (WAC) for all items
Stock Ledger postings to GL	**In-frequent,** delayed – Period	**Perpetual,** method – Daily / Weekly / Period

Cost Method of Accounting | KPIs

Table 2 – Advantages of cost accounting over retail accounting

Key Considerations for the Transition

In addition to assessing the potential impact on financial and business metrics, retailers must evaluate and put in place several other key processes leading up to the transition from retail to cost accounting.

Transition timeline: To minimize disruption, it is important to choose an ideal time for transitioning to a different method of accounting. It is best to change accounting methods at the start of a new financial year rather than during an open financial year. This enables a smooth transition by ensuring consistency in financial reporting within a financial year and simplifies financial and auditing requirements.

Planning systems: Retailers must assess the impact of cost accounting transition on different functional areas and systems. For instance, in addition to stock ledger and general ledger systems, planning systems may also need to be modified to align with cost-centric planning and metrics. With different systems hosted on different technology stacks, and owned by different product groups, retailers must consider inter-system dependencies to determine the rollout window for transitioning to cost accounting.

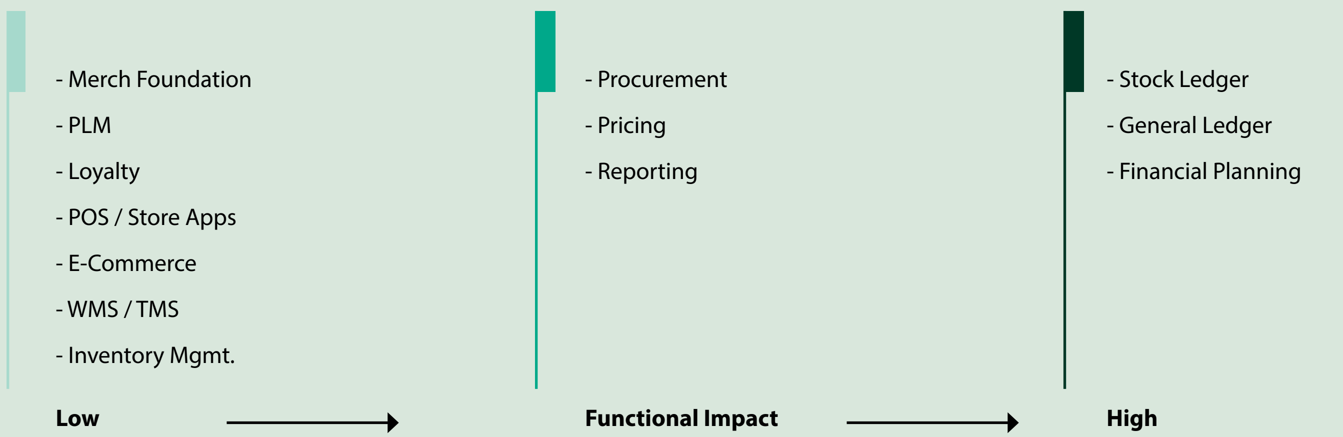


Figure 1 – Impact of accounting transition on systems and processes

Reporting platform: Retailers must invest in building a reporting platform for a system-wide assessment of changes to inventory and accounting metrics. The reporting platform must be thoughtfully designed to support reporting needs during and after accounting cutover. This will allow business teams to effectively evaluate the impact of the cost accounting transition on the financials, develop confidence before production roll-out, and streamline the entire accounting transition journey.

Auditor involvement: Involving auditors too late during accounting transition or involving them minimally can become an obstacle during accounting transition rollouts. Business and technical teams should realize that, in such a scenario, they may in future need to spend significant effort in responding to auditors' queries. To ensure a smooth production rollout, it is a good practice to involve auditors from the beginning of the accounting transition journey so they are well-informed and part of the entire transition.

Item cost initialization: From a stock ledger perspective, switching to cost accounting involves four critical activities. These are updating item costs, enabling cost accounting configuration, rebuilding stock ledger at cost valuation, and addressing reporting/auditing requirements. Accurately initializing item-location cost is an important element in cost accounting cutover. Retailers must not only choose between weighted average and standard cost, but more importantly what item-location cost to initialize for the switchover to cost accounting. Given that accurate item-location cost may not be available, retailers may consider using supplier cost to initialize item-location cost.

System configuration changes: In merchandising packages such as Oracle Retail, switching to cost accounting also requires changes to the system configuration. In addition to obvious system configurations that alter system behavior for cost accounting, retailers must holistically assess all cost-related system configurations and their impact on both IT systems and business processes. For example, retailers may continue to calculate markup on retail instead of on cost, even after switching to cost accounting and a change to the system configuration to calculate markup on cost may not be required.

Cost Method of Accounting | Transformation Activities

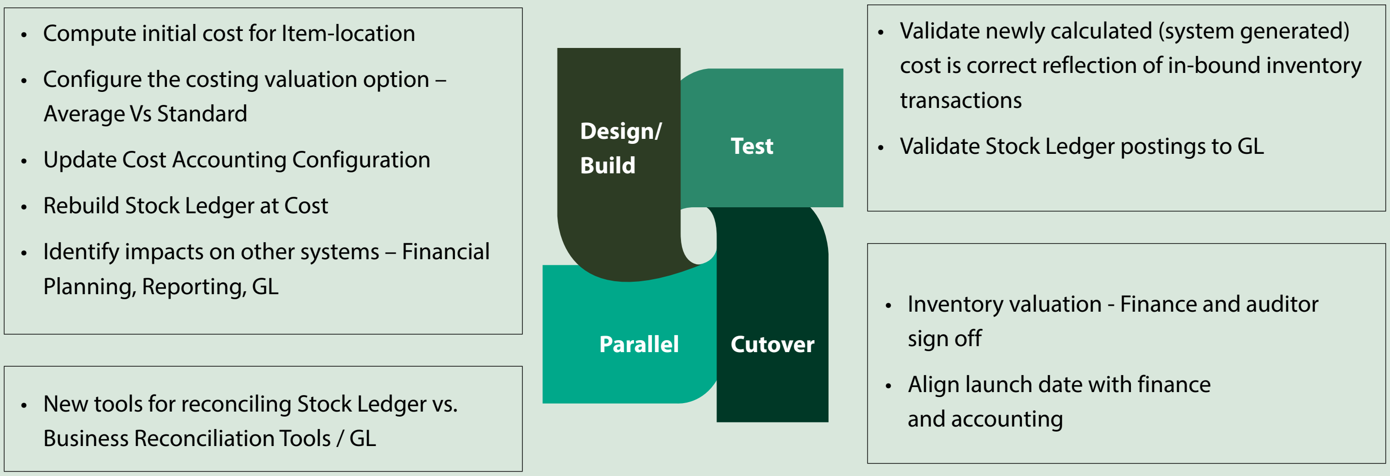


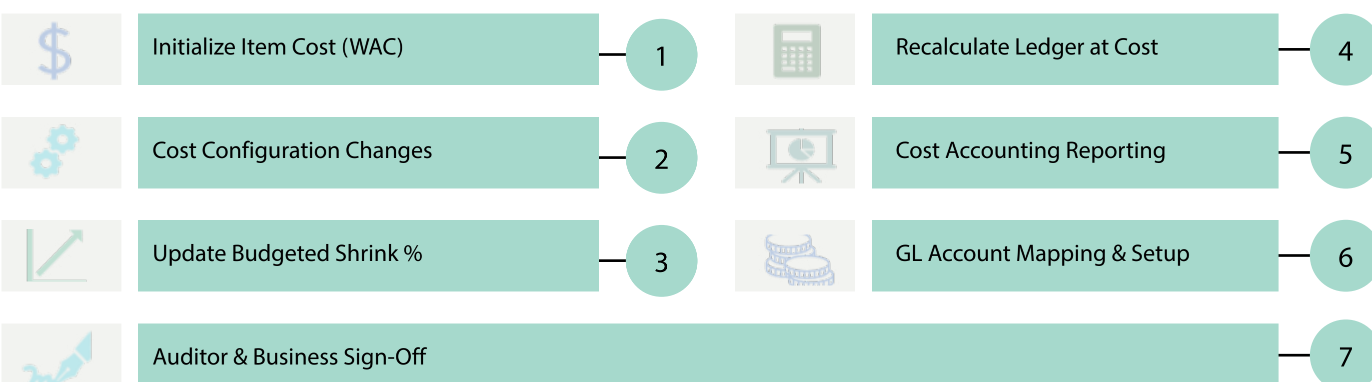
Figure 2 – Activities during the transition from retail to cost accounting

Stock ledger initialization: Calculating beginning of period inventory to initialize stock ledger with cost valuation of inventory is another important execution step. Thoughtful consideration must be given to the approach for stock ledger recalculation. In Oracle Retail, both weekly and monthly ledgers need to be reinitialized by revaluing available inventory at cost.

Evaluating shrinkage impact: Switching from retail to cost accounting may affect shrinkage and budgeted shrinkage percentages. Performing a physical inventory count close to accounting cutover will ensure minimal accumulation of shrink before accounting transition and minimize the impact of shrink on stock valuation. This will also improve inventory and stock ledger accuracy.

Monitoring inactivity: It is a good practice to perform a review of inactive departments and merchandising hierarchies that may not contain any inventory but may contain residual dollars in ledger. Ledgers for such inactive merchandising hierarchies should be cleaned up before the accounting transition to ensure accuracy in rebuilding ledger at cost.

Reporting and sign off: Adequate consideration must be given to reporting, data retention, and sign-off requirements from both the business and auditors. Requirements gathering for this step should happen at the design stage of the cost transition journey. This will ensure that audit and reporting requirements are correctly estimated and addressed during the project build. For instance, requirements to retain cost, transactional, inventory, and ledger data before and after accounting cutover may require the involvement of platform teams to provision necessary storage capacity for data retention. Developing reports to compare retail vs cost accounting metrics or to assess impact of late-posted transactions during cutover involves significant effort and should be a key element of project design.



Ledger Revaluation at Cost – Key Constituents

Figure 3 - Key constituents of ledger re-evaluation at cost

Setting up a Parallel Cost Accounting Instance

For seamless transition from retail to cost accounting, building a shadow cost accounting instance while still operating business using retail accounting is an effective and pragmatic approach. With such a platform, businesses can identify the impact on accounting and financial metrics across the enterprise early in the transition. With a parallel cost instance in place, reports can be generated to compare business metrics in both retail and cost accounting. For example, accounting teams can compare inventory valuations at ledger and location levels in retail and cost accounting, and analyze locations/hierarchies with high variances to determine the root cause.

Another key benefit of a parallel cost instance is to build accurate WAC overtime based on transactional activity before actual production rollout.

Building and maintaining a parallel accounting instance involves additional costs, but its benefits outweigh the expenses. Implementing a shadow cost instance before production rollout allows business groups to effectively evaluate the impact on financials and analyze variances, allowing them to adjust processes and metrics before production rollout, thus reducing risks during accounting transition.

Align Auditors and Business partners

Cost Instance	Retail Instance
Maintain item cost based on inventory receipts	Estimated cost at ledger/ hierarchy level
Inventory valuation using item cost	Inventory valuation using Retail & mark-on %
Measure Item level profitability	Measure ledger/hierarchy level profitability
Perpetual GL feed - Daily/ Weekly/Monthly	Periodic/Monthly GL feed
Compare Retail vs Cost stock valuation	

Platform to support accounting cutover

Cost Method of Accounting | Parallel Cost Instance

Figure 4 – Setting up a parallel cost accounting instance during the transition

Conclusion

Considering the benefits of cost accounting in accurately measuring inventory value and profitability, retailers are increasingly looking to switch to this method of accounting. However, retailers should execute an accounting transition with careful consideration as switching from retail to cost accounting not only involves altering system capabilities, but also entails business and financial impact. For a seamless accounting transition, developing an operational platform that allows comparison of key retail and cost accounting metrics can be a great enabler. It is also important to involve all key stakeholders, including auditors, from the beginning to ensure a smooth transition. Finally, implementing a parallel cost accounting instance before the cutover will help analyze risks, plan mitigation, and ensure a seamless cutover to the new cost accounting system. Infosys, with its vast experience in successful accounting transitions, brings deep industry expertise and insights that retailers can leverage to successfully implement their transformation.

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