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Central Stores: External Sales Report to Management

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Summary

The objective of our review was to determine whether or not the county is covering its costs in providing purchasing services to external customers of Central Stores. We analyzed customer data to better understand how internal and external customers compare on several factors and whether the fee paid by external customers covers the costs associated with fulfilling their orders. We determined that the revenue brought in by external sales covers the variable cost (personnel costs) associated with making the sales. However, it is less clear that the external sales program covers its share of the total cost of Central Stores' operations, which also includes warehouse and other fixed costs as well as county overhead costs. Our analysis showed profit margins ranging from negative 5 percent to positive 5 percent, depending on how we allocated the fixed and overhead costs.

Background

Central Stores is part of the Multnomah County Materiel Management section of the Department of County Management. Central Stores provides goods and supplies to county departments and other agencies throughout Oregon. In Fiscal Year 2008 (FY08) customers made more than $6 million in purchases from Central Stores (CS): $3,766,000 by Multnomah County internal customers and $2,295,000 by external customers.

CS has more than 70 external customers, including agencies in all 36 Oregon counties. The majority of these are family planning clinics managed by other counties and not-for-profit organizations eligible for federal family planning funding. CS is able to purchase contraceptive drugs and supplies at a discount by taking advantage of consortium contracts and volume purchases. For more than 20 years, CS has provided buying services, centralized receiving, inventory stocking and distribution and has managed returns for these external agencies.

Multnomah County CS charges its external customers a 10 percent fee for providing this service, with a slightly higher fee for certain low-cost materials. This fee was set by Multnomah County resolution and is subject to change by the Board of County Commissioners.

Sales to external customers accounted for approximately 38 percent of the dollar amount of purchases from CS in FY08. The high dollar amount of external purchases resulted from the relatively high cost of the items purchased rather than the number of orders or items: external customers accounted for about 14 percent of total items sold and only 10 percent of orders. Fees charged to external customers totaled approximately $250,000 and accounted for about 23 percent of CS's $1.1 million FY08 operating expenses. [1]

Exhibit 1: Comparison of Internal and External Customers

Customers	Sales	%	Materials Sold	%	Orders Filled	%	Average Sale per Order
Internal	$3,765,887	62%	47,506	86%	13,310	90%	$ 283
External	$2,295,050	38%	7,736	14%	1,494	10%	$1,536
Total	$6,060,937	100%	55,242	100%	14,804	100%	

Source: Purchase data from SAP download of reservations for FY08

Allocating Costs

CS provides purchasing and warehouse services to both internal and external customers. Because the external sales program does not use dedicated staff or resources, we can only estimate the cost of selling material to external customers. For this estimate, we considered the variable costs to be the personnel costs – salary and benefits – needed to process external sales because these resources could be most easily used for other activities. The remaining costs, such as those related to fixed warehouse expenses and county overhead, are included in the calculation of total costs.

Using payroll data and FY08 actual CS expenditures, we developed four cost allocation models to estimate the operation's costs. We based three of our allocation models on proxies for sales activity – or the amount of resources necessary to support sales – and one on self-reported measures of staff time devoted to external sales. The dollar amount of sales, the number of unique items sold in each order, and the number of orders filled all served as our proxies for sales activity.

Staff expenses include personnel costs[2] for CS staff who service external customers. Warehouse expenses include county indirect expenses, building expenses, telephone services, county IT and data processing, and other miscellaneous expenses. Exhibit 2 below shows the results for each model based on variable costs and total costs.

[1] Budget estimate may include some expenses associated with the Fleet or Road Warehous

[2] The amount of cost allocated for individual personnel was different for some staff members, depending on duties and responsibilities

Exhibit 2: Cost Allocation Models and Resulting Net Income - External Customers

	A Sales Dollar Amount (38%)	B Materials Sold (14%)	C Orders Filled (10%)	D Staff Reported (various)	E Average of Methods
Purchasing and Handling Fees (estimated) [3]	**$250,000**	**$250,000**	**$250,000**	**$250,000**	**$250,000**
Variable Costs (personnel)	**188,238**	**97,018**	**80,244**	**113,017**	**119,629**
Fees Less Variable Costs	**61,762**	**152,982**	**169,756**	**136,983**	**130,371**
Fixed and Overhead Costs	**184,913**	**68,126**	**48,661**	**24,331**	**81,508**
Net Income	**(123,150)**	**84,856**	**121,095**	**112,652**	**48,863**
Profit Margin	**-5%**	**4%**	**5%**	**5%**	**2%**

A. Allocation Based on Percent of Sales Dollar Amount

Allocating the cost of the external sales business on the basis of dollar amount of sales is consistent with how CS allocates costs for internal customers. External customers account for 38 percent of the sales activity of CS. If assessed on sales activity, allocated costs would total $373,150, yielding a net loss of about 5 percent of total sales. See Exhibit 2, Column A above.

B. and C. Allocation Based on Sales and Warehouse Activity

Allocating costs on the basis of materials sold and orders processed assigns costs based on the time it takes CS staff to support the external sales business. Sales to external customers generate 14 percent of the total material line items sold and 10 percent of orders filled (reservations). In each case, the business is profitable, with a profit margin of 4 percent for the materials allocation and 5 percent when we allocated costs by orders. See Exhibit 2, Columns B and C above.

D. Allocation Based on Staff-Reported Time

In calculating our Staff-Reported allocation, we used staff estimates of hours worked on external sales and estimated 5 percent of warehouse costs to account for use of warehouse space and other resources. If costs were assessed on resources used, the cost would be $137,348 with a net income of $112,652 and profit margin of 5 percent. See Exhibit 2, Column D above.

[3] Purchasing and Handling Fees (revenue) includes the 10% fee plus some additional fees collected from external customers

Managing Revenue and Expenses

It is difficult to manage potentially unpredictable revenue from external customers with expenses that are essentially fixed in the short-term. A number of factors contribute to the instability of external revenues. For example, many external customers are eligible to purchase materials using the same multi-state or consortium contracts CS uses and could do so without paying CS's 10 percent handling fee. In those instances where CS does get a volume discount not available to its customers, the discount is usually less than the 10 percent fee. Moreover, CS does not have any minimum purchase or other purchase commitment requirement for its external customers, giving the customers the freedom to choose whatever supplier they wish without risk of penalty.

The convenience of purchasing through CS is a compelling reason for customers not to leave, but as resources get tighter, losing customers is a real possibility if these customers believe they can cut costs by making their own purchases. For example, the Multnomah County Health Department reduced its purchases of supplies through CS and chose to absorb the administrative cost of making these purchases directly from suppliers rather than pay CS for the service. At the time, the CS internal service charge was nearly twice the handling fee paid by external customers for the same materials. The Health Department pharmacy now purchases about $250,000 worth of family planning supplies directly per year rather than going through CS.

The loss of the convenience of purchasing through CS constitutes a switching cost for external customers. However, for larger customers that are likely to already have purchasing operations, this cost may not be as high. Large customers may even be able to take advantage of some of the same volume discounts available to CS and the Health Department. Even if the customers did not leave CS completely, they could purchase the few expensive items they need directly, saving the handling fee, and continue to buy lower cost items through CS. These less expensive items disproportionately affect CS fee revenue.

Exhibit 3: Top Five External Customers by Sales Amount

Customer Name	Sales	Percent of Total Sales
Washington County Family Planning	$302,257	13%
Douglas County Family Planning	$192,837	8%
Deschutes County Family Planning	$128,599	6%
Jackson County Family Planning	$119,036	5%
Linn County Family Planning	$114,455	5%
Total	$857,184	38%

While customers and the external sales revenue could be lost with little or no warning at any time, the costs associated with providing the external sales service are more difficult to reduce quickly. Finance, purchasing, and warehouse activities associated with external sales are completely integrated into the overall CS operation. For example, the steep drop in internal sales from FY07 to FY08 did not result in a corresponding decrease in expenses.

Assuming that CS will continue to exist with or without an external sales operation and that the purchasing and handling fees from these sales more than cover the variable cost of providing that service, these sales help to reduce costs for internal county customers. For example, without the FY08 external sales revenue, charges to departments could have increased another 4 percentage points to cover expenses. However, any evaluation of the CS operation as a whole should consider the fact that the fees charged for external sales may not cover the total cost of providing the service in the future.

Scope and Methodology

During this review, we interviewed staff responsible for several facets of the entire CS operation as well as the larger FREDS Division and the Health Department. We also interviewed officials from other jurisdictions, including the State of Oregon Department of Human Services. We collected and analyzed internal and external sales data for the period between July 1, 2007 through June 30, 2008 and payroll data for CS staff. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Recommendations

1. In the near-term, consider creating incentives, such as volume purchase discounts or discounts for purchase commitments, to reduce the likelihood of external customers leaving the program.

2. Any significant changes in the external sales operations – such as investment or expansion – should consider the total costs of the operation.

3. Management should evaluate the potential disincentives created by its rate structure – specifically in areas where CS charges internal customers roughly twice the rate it charges external customers for the same products and services.