



# **Drago College Store Inventory and Financial Review**

June 17, 2021

Report No. 170-21

Office of Internal Audit & Risk Management

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# Missouri State University™

W E S T P L A I N S

**DATE:** June 17, 2021

**TO:** Sharon Holland, Manager  
Dr. Angela Totty, Dean of Student Services

**CC:** Dr. Dennis Lancaster, Interim Chancellor  
Rachael Dockery, General Counsel  
Clifton M. Smart III, University President

**FROM:** Natalie B. McNish, Interim Director, Internal Audit and Risk Management  
Grant P. Jones, Audit Assistant

## Drago College Store

### BACKGROUND

The Drago College Store is located within the newly constructed (2019) Hass-Darr Hall and serves as the official campus retail store for course materials, supplies, electronics, souvenirs, food items and clothing. Gross sales average more than \$650,000 per year. The store is staffed with a manager, a buyer, and eight to ten part-time student employees.

Inventory procedures are typically confirmed by the Office of Internal Audit and Risk Management (office) annually; however, due to the COVID-19 pandemic, this audit procedure was not applied during the year ended June 30, 2020. As a result, physical inventory observation and testing was scheduled for April 30, 2021. In addition, the prior audit report issued by the office (Report #155-19, issued September 30, 2019) acknowledged concern for a downturn in financial operations. This report also follows-up on those concerns. In addition, Dr. Angela Totty, Dean of Student Services, and Dr. Dennis Lancaster, Interim Chancellor, requested assistance to evaluate the financial condition and practices of the store prior to the start of the audit.

The industry as a whole has been struggling to adapt to declining traditional book sales, decreasing enrollments, and increased online competition. This struggle is evidenced in the store's comparative income statements for the years ended June 30, 2016, through 2020. In addition, we have projected financial data for the year ending 2021 and forecasted the same for the years ending 2022-2025.

A customer satisfaction survey was sent to 100 students and 100 employees to gauge their use of and satisfaction with the store, its processes, and its inventory. Responses and a sample of comments received are documented in Appendix A.

## OBJECTIVE AND SCOPE

The objectives were to review and evaluate the accuracy of the Drago College Store inventory and the current financial condition. The scope included, but was not necessarily limited to, the year ended June 30, 2020 through April 30, 2021.

## SUMMARY

The financial condition of the store has deteriorated over the past several years and additional procedures to increase monitoring activities and operating income while decreasing operating expenses are needed. In addition, improvement is needed in management of aged inventory (non-course material), unsold course materials ("dead books"), and management should consider elimination of the Trade book department. Also, the store should research emerging course material delivery models available and implement a model that serves its students and helps increase or at a minimum, stabilize operating income.



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Natalie B. McNish, CFE, CGAP  
Interim Director  
Office of Internal Audit and Risk Management



Grant P. Jones  
Audit Assistant

Audit Field Work Completed: May 13, 2021

## OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

### 1. Financial Condition

The financial condition of the Drago College Store has deteriorated over the past five years and without diligent effort to reverse this trend, the store could require subsidization by the end of fiscal year 2025. Comparative income statements using actual data were compiled for years ended June 30, 2016-2020. Using this information and actual figures for July 1, 2020 through April 30, 2021, a projected income statement for the year ended June 30, 2021 was compiled. (See also Appendix A).

<b>Actual &amp; Projected Comparative Income Statement</b>						
<b>Year Ended June 30,</b>						
	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>
Operating Income	\$ 311,582	259,136	236,404	224,602	198,682	185,128
Less: Operating Expenses	192,923	185,439	192,741	254,307	217,914	224,890
<b>Net Operating Income (Loss)</b>	<b>\$ 118,659</b>	<b>73,697</b>	<b>43,663</b>	<b>(29,705)</b>	<b>(19,232)</b>	<b>(39,763)</b>
Less: Transfer to Operating	78,320	78,320	78,320	78,320	78,320	78,320
<b>Net Income (Loss)</b>	<b>\$ 40,339</b>	<b>(4,623)</b>	<b>(34,657)</b>	<b>(108,025)</b>	<b>(97,552)</b>	<b>(118,083)</b>
Beginning Net Assets	925,829	966,168	951,545	926,888	818,863	721,311
<b>Ending Net Assets</b>	<b>\$ 966,168</b>	<b>961,545</b>	<b>926,888</b>	<b>818,863</b>	<b>721,311</b>	<b>603,228</b>

Analysis completed determined total operating income is trending downward at an average of more than \$25,000 per year and operating expenses are increasing on average by approximately \$6,000 per year. Using these averages, we forecasted financial data for fiscal years 2022 – 2025 as follows:

<b>Forecasted Financial Condition</b>				
<b>Year Ended June 30,</b>				
	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
<b>Net Operating Income (Loss)</b>	<b>\$ (71,447)</b>	<b>(103,131)</b>	<b>(134,816)</b>	<b>(166,500)</b>
<b>Net Income (Loss)</b>	<b>\$ (149,767)</b>	<b>(181,451)</b>	<b>(213,136)</b>	<b>(244,820)</b>
Beginning Net Assets	603,288	453,461	272,010	58,874
<b>Ending Net Assets</b>	<b>\$ 453,461</b>	<b>272,010</b>	<b>58,874</b>	<b>(185,946)</b>

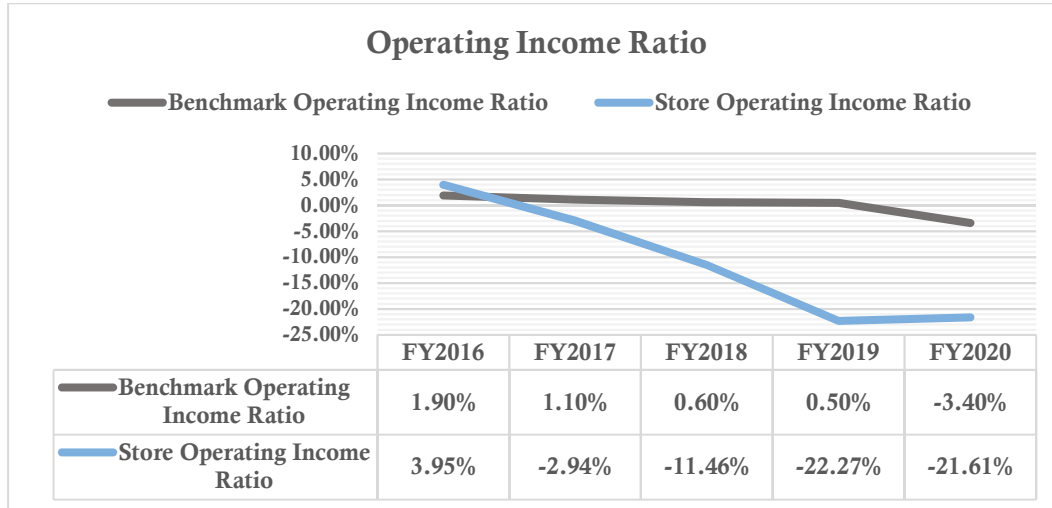
As shown by this forecast, significant subsidization could be required for operations during fiscal year 2025 if current conditions are not stabilized and/or reversed.

#### Financial monitoring

The Store Manager completes monthly reconciliations between the point-of-sale and accounting system and carefully analyzes any discrepancies. She also reviews outstanding credits, pending and outstanding invoices, purchases made using the store procurement card, and completes a detailed analysis of sales volume by category for the current and prior year. All of this work is accurate, informational and well documented; however, it does not provide sufficient information to monitor the financial condition identified above. Monthly income statements and other financial reviews should be prepared to ensure changes made have the desired impact and the overall condition does not worsen. In addition, these financial documents should be shared with administration for the ongoing monitoring of the condition.

## Operating income

Annual gross sales have decreased more than \$200,000 between the years ended June 30, 2016 and 2020, which has caused the operating income ratio to decline faster than industry standards reported by the Independent College Bookstore Association (ICBA) in the 2020 report.

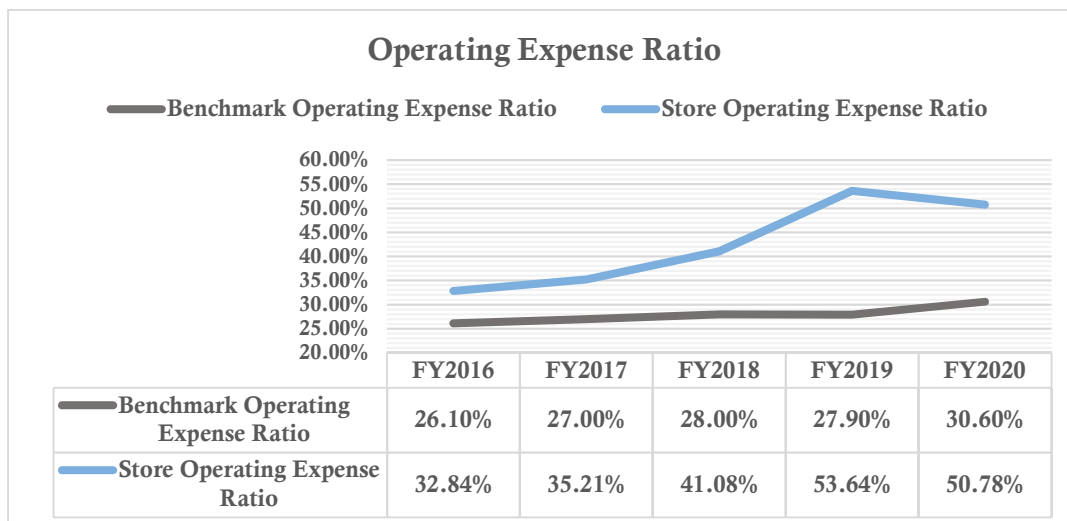


While improvement is projected for the year ended June 30, 2021, it is not significant enough to change the financial forecast.

A portion of this decline has been recovered through interest income earned on the store's claim on cash. During the period reviewed, interest rates increased in a growing economy and therefore, interest revenue earned by the store increased to more than \$30,000 in the year ended June 30, 2018. However, this is not sustainable as cash is currently being used to supplement operations. In addition, this is not reliable as rates have dropped significantly.

## Operating expenses

Annual operating expenses have increased nearly \$40,000 between the years ended June 30, 2016 and 2019, which has caused the operating expense ratio to increase much faster than industry standards reported by the ICBA.



This steady increase in expense was stalled in the year ended June 30, 2020, as the store closed in response to the COVID-19 pandemic; however, the driver of this increase is largely related to rising personnel costs, specifically, minimum wage increases provided to part-time employees and cost-of-living wage increases and benefit contribution percentage increases paid to/for full-time employees.

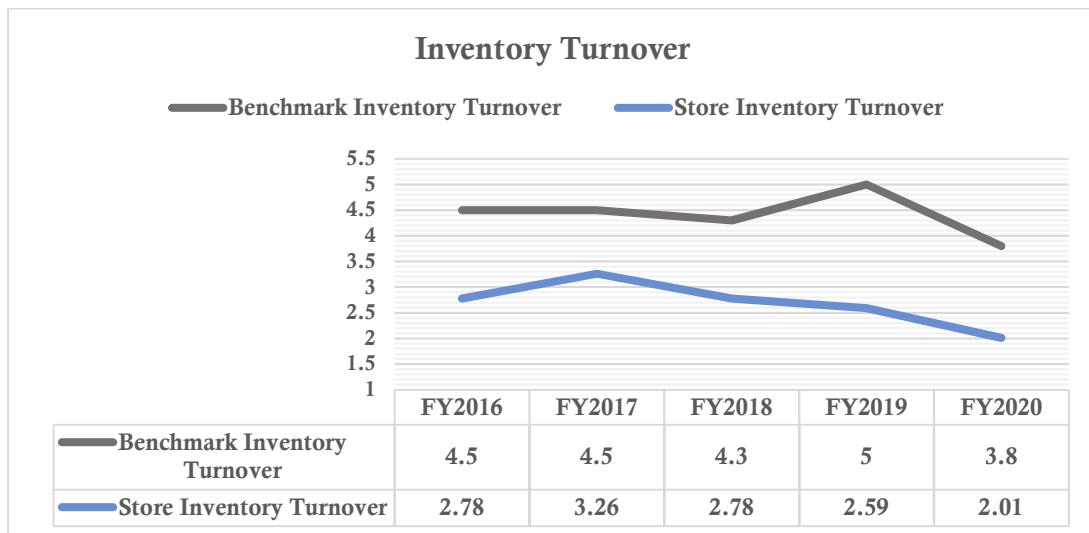
Additionally, a change in accounting practice was noted during fiscal year 2020 allocates the portion of bad debt related to uncollectable store charges to the store's fund, instead of absorbing the store's loss in the operating fund. While this provides a more accurate picture of actual operations, it also increases expenses by an estimated \$5,000 per year.

We also noted some one-time expenses during the year ended June 30, 2019 related to the store's relocation to Hass-Darr Hall. These expenses, totaling approximately \$35,000 are not anticipated to reoccur.

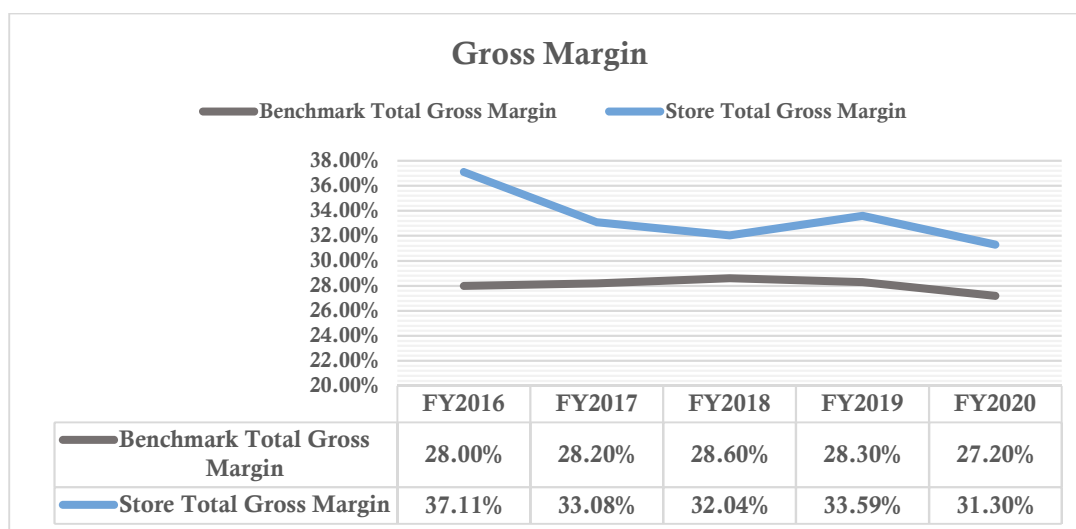
### Inventory turnover and gross margin

The store's inventory turnover is well below industry standards while its gross margin is significantly higher. Inventory turnover is a financial ratio which shows the number of times the store has sold and replaced inventory during a specified period of time. Gross margin is a financial ratio which states the percentage of each dollar of gross sales which is retained as income. These two ratios are related in that if margins are not competitive, inventory turns will be lower.

Using industry benchmarks provided by the ICBA in 2020, we compared the store's inventory turnovers.



The same review was completed for the store's gross margin:



Turning inventory at a more frequent pace allows the store to meet the changing demands of the customer in a timelier fashion, reduces obsolescence, and often increases sales volume and operating income.

While the store may not be competing with local brick-and-mortar stores for course materials, management must consider other competitors such as Amazon®, Chegg®, & Barnes & Noble®. According to survey results (see Appendix B) these were the most often utilized by students when not obtaining course materials through the store. Competitive pricing may decrease gross revenue per item, but could increase gross sales and therefore, improve the financial situation.

Discounting and disposition of aged and unsold inventory (see Finding 2) would also aid in the increase of turnover and reduction in margin needed.

### Enrollment

Enrollment of degree seeking students has declined during the period reviewed. Less degree seeking students equates to fewer traditional customers to serve and lower sales. According to the campus' Enrollment Management Plan, total degree seeking students have decreased 28 percent between academic years 2016 and 2020. The document goes on review dual credit (high school students), non-traditional students (adults typically living off-campus), and traditional students (those most likely to be customer) and determines total enrollment of traditional students has fallen 13 percent during the same period.

### Conclusion

It is essential for management, in collaboration with administration, to address the financial condition of the store in both the immediate- and long-term future. The current financial trends in both income and expenses are not sustainable.

### Recommendation

Management, in collaboration with administration, should develop additional financial monitoring procedures to carefully and consistently monitor the financial condition of the store, work together to increase operating income and decrease operating expenses where able, and adjust procedures to bring financial ratios into line with industry standards. As the administration addresses campus enrollment, the store should be engaged and align its procedures to attract those students comprising the current and future targeted populations.



## Management's Response

*Management and administration agree to developing additional financial monitoring reports that more clearly informs the financial condition of the store. Management will work with the Baker Bookstore personnel to develop the needed reporting tools. As early as 2017, Management recognized there would be an impact on the financial position due to changes being made in the academic course material selections. Administration was apprised of the concern at that time and each year as course materials are selected.*

## 2. Inventory Management

Improvement is needed in the store's management of inventory on hand. Implementation of the following recommendations will likely aid in strengthening the store's financial condition discussed above.

### A. Inventory procedures

Auditors observed and tested the annual physical inventory at the store on April 30, 2021 with no significant exceptions. The shrinkage ratio based upon year to date sales (through April 26, 2021) was 0.02%. The National Retail Security Survey Final (NRSSF) and the ICBA reported average shrinkage ratios of 1.62% and 0.56% respectively. The Drago College Store's shrinkage ratio is far less than either of these national benchmarks.

### B. Aged inventory (non-course material)

The store has not developed a system to review inventory by order date or last sale to determine the age and obsolescent status of items, apply consistent or significant markdowns to reduce inventory, and when necessary, dispose of non-moving items.

Based on a review of detailed inventory reports generated in April 2021, the bookstore had 19,160 items on-hand. Forty-nine percent (9,372) of these items were last ordered between 2005 and 2018, and 1,114 of these items are more than ten (10) years old.

In addition, 2,963 (15 percent) items in inventory have no recorded sales in the past two (2) years and 2,400 items purchased before 2021 have no sales history as of April 26, 2021. One (1) item in inventory has had no sales since August 31, 2007.

The age of these items indicates they should be significantly marked down or disposed of, but our review determined only 171 of the 9,372 items (two (2) percent) were discounted. The store manager indicated broken size runs and discounted items are placed on clearance racks and provided an initial 20-25% discount. If the items do not move, the discount is increased up to 50 percent or during special sales only, discounts will reach 60 percent. Items deemed unsellable are written off as identified.

As a result of holding these aged items, the store does not have space for new, more sellable items which could offer a larger profit and help reverse the financial condition noted above.

### C. Unsold course materials ("dead books")

The store does not adequately dispose of unused course materials ("dead books") in a timely manner. While it is understood the store may decide to retain some course materials between terms thereby reducing shipping costs and possibly passing savings on to students, unsold course materials ("dead books") represent a potential liability for the store. Inventory is recorded in the accounting system at cost. The continual and often significant depreciation in value of dead books causes inventory to be overstated and upon actual disposition, results in a loss for the store.

In addition, any book not adopted in more than one (1) academic year is unlikely to be adopted for future terms. As of April 30, 2021, the store held 294 “dead books” with a value of nearly \$9,000. Of these books, 238 were last adopted for the Spring 2020 term or before, and 100 were last adopted at least three (3) academic years prior, with the oldest book being last adopted for the Fall 2013 term. According to the Manager, the majority of these items are the result of late returns from those students who participate in the “rental program.”

To limit unsold course materials and maximize return allowances, books should be returned to publishers after the third week of classes in the associated term. If a book cannot be returned to the publisher, it should be liquidated via wholesalers, donated in accordance with policy, or destroyed.

#### **D. Tradebooks**

The store’s inventory also includes Tradebooks, which are books intended for general reading (e.g., novels, biographies, cookbooks, etc.), but also includes study aids and preparation materials for standardized tests (e.g., GRE, GMAT, MCAT, etc.).

Recent changes in this industry, driven by increased use of digital formats of reading materials as well the overall market share dominance of Amazon®, makes this product line unviable for stores that do not engage in significant promotion of or the hosting of special events for the products.

Of the 612 Tradebooks in inventory at April 26, 2021, 70 percent of the items in this department had no sales activity in one (1) year or more. Many of these items are included in the aged inventory numbers reported in B above.

#### **Recommendations**

- A. None. Management should be commended for their diligent tracking of inventory resulting in a shrinkage ration far below the national benchmarks.
- B. Take action to dispose of aged inventory on hand and develop procedures to routinely analyze the age of inventory items and items which are not selling. Further, the store should adopt a more aggressive markdown and disposal policy.
- C. Adopt procedures to return unsold course material to the publisher after the third week of classes in the associated term. For items which are no longer returnable, management should dispose in the most beneficial method while complying with applicable policies.
- D. Consider elimination of the Tradebook department.

#### **Management’s Responses**

- A. *Thank you for the acknowledgement of the hard work done by management and staff to deliver consistent inventory practices.*
- B. *Management will implement the recommendation to dispose of aged inventory and develop procedures to routinely markdown and dispose of inventory.*
- C. *Closer attention will be given to the return of course materials and disposal of materials unable to be returned.*
- D. *Management will eliminate the Tradebook department which will also assist with aged inventory numbers.*

### **3. Course Materials**

The store has not embraced non-traditional course material delivery methods in a comprehensive fashion. In addition, the established “rental program,” which provides course materials to athletes and ambassadors at no cost to the student, results in losses for the store because materials provided in new condition are returned as used which requires an adjustment to value in inventory. Nearly 25% of write-offs recorded for the five (5)-year period ending June 30, 2020 related to losses related to this program.

As the cost of traditional print textbooks have increased, students have become unwilling or unable to afford required course materials. In the early 2000s, the industry developed various rental models which allowed the resellers of a traditional print book to divide profits across multiple uses of a single printed copy, thereby increasing revenues per published product at a lower cost per customer. This is still utilized on many campuses across the country; however, it is not without risks and some smaller institutions without a larger market share, find themselves unable to compete against online competitors such as Amazon® and Chegg®. Over time, the rental models have become overshadowed by a shift to digital access programs. These programs are divided into two types, inclusive and equitable access.

Comprehensive inclusive access programs provide students access to course materials through a learning management system (LMS). This model is more convenient for the student and carries less risk for the store in terms of unsold inventory. The fee for this access is negotiated through the publisher and often provides access to materials at 50-70 percent below the retail market.

The other access program gaining ground is called an equitable access program. With an equitable access program, the student pays a per term or per credit hour fee which allows that student access to course materials for all registered courses during the specified term enrolled. In this model, costs are shared across the entire student body, college, or major and incorporated into other fees already charged. This model is meant to bridge socioeconomic gaps which exists in all institutional communities.

The Drago College Store has not fully embraced any of these models in a comprehensive manner. The current “rental program” operated is actually a lending of materials to specific groups of students at no fee and often at a loss for the store. Some faculty have adopted materials with electronic access and the store does manage the sale of those access codes, but a comprehensive program could provide affordable options to students and may also allow the store to better compete with online retailers. The Baker Bookstore on the Springfield campus has embraced some of these models and may offer collaboration opportunities. In addition, there may be opportunities to negotiate with publishers as a system rather than individual stores to gain buying power for the Drago College Store it may not have due to its smaller market share.

#### **Recommendations**

Research the various course material delivery options available through established vendors and potential joint ventures with the Baker Bookstore on the Springfield campus, develop a strategy that meets the student body needs, implement new programs with significant marketing, and monitor the financial viability of new programs to ensure the store’s financial condition is not worsened.

#### **Management’s Responses**

*Management and administration will begin to review the alternative delivery options available to determine how to best meet the student body’s needs. Management will work with Baker Bookstore to review any potential joint ventures.*

## Appendix A Summary of Survey Responses

In conjunction with our audit of inventory and financial aspects of the Drago College Store, we also sent a short survey to the 100 students and 100 employees. We received 39 responses (11 students and 28 employees) as follows:

### Question 1:

Overall, how would you rate the Drago College Store? (Provided 1-5 star options)



Average Rating 4.39

### Question 2:

How often do you visit the Drago College Store or website?

● Daily	2
● Weekly	3
● Monthly	20
● Once per session	11
● Never	3



### Question 3:

Does the store generally have what you are looking for in stock?

# 95% said "YES"

### Question 4:

If you purchased your course materials from the Drago College Store, were you able to obtain all needed materials before the start of classes?



Yes	14
No	3
N/A	22

Question 5:

What other sources do you use to obtain your course materials?



Question 6:

Do you recall seeing any advertisement of promotions or events at the Drago College Store this semester?



85% YES  
15% NO