

An Inventory Letter from Carter's to Kohl's – What Could Go Wrong?

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Introduction

Mr. Johnson had a highly valued business relationship with Mr. Elles. Johnson was the executive manager of Kohl's Corporation's profitable Children's Division, while Elles served as Carter's, Inc., executive vice-president of sales. All seemed to be going well until Elles asked Johnson to sign a letter that misstated the amount of Kohl's discounts for the prior year's purchases. These two executives had previously negotiated discounts totaling \$16.5 million, which Kohl's had already taken. The letter stated the amount as approximately \$12.1 million, an understatement of \$4.4 million. Elles explained that the letter concerned Carter's "internal budgetary issues ... not financial statement issues" (Hornbeck, 2012). To Johnson, the signing of the letter apparently seemed like a necessary formality in order to maintain Kohl's favorable discounts. Johnson also desired to keep Kohl's, and particularly its Children's Division, as cost-effective as possible. Kohl's financials would not be affected by Johnson signing the letter. What harm could come from signing the letter?

Kohl's opened its first department store in 1962 in Brookfield, Wisconsin. Within 50 years, Kohl's had expanded its operations to over 1,100 locations in 49 states with revenues exceeding \$16 billion (Kohl's Fact, 2014). Kohl's went public in 1992 and eventually became the third largest department store in the world (Deloitte, 2014). A sizeable portion of Kohl's revenues came from its Children's Division, which generated annual sales of about \$2 billion.

Carter's began its operations in 1865 in Braselton (now a suburb of Atlanta, Georgia) by William Carter. With its "Carter's" and "Oshkosh B'gosh" brands, the company grew to become the largest "branded marketer in the United States of apparel made exclusively for babies and young children" (Carter's, 2015). Carter's operated more than 700 company-owned stores. It also sold merchandise to other large retailers; including Walmart, Target, Toys "R" Us, Costco, JCPenney, Macy's, Sears, and Kohl's. Kohl's was Carter's largest customer (SEC, 2012) and accounted for approximately ten percent of Carter's sales (Carter's, 2010). Carter's market value had grown rapidly as its stock had nearly doubled in price since its initial public offering (IPO) less than four years earlier (Yahoo, 2015). Elles, as vice-president of sales, played a key role in Carter's success by cultivating profitable arrangements with other major retailers. Elles, however, negotiated a

special arrangement with Johnson. In fact, Elles was providing discounts greater than those Carter's had authorized him to allow.

Carter's and others in the clothing industry routinely gave discounts, also known as accommodations, to its retail customers. These accommodations or discounts helped their customers pay for "costs related to inventory clearance and sales promotions and to allow customers to achieve a desired profit margin on their subsequent resale of Carter's products" (SEC, 2012). For the retailer, these discounts reduced inventory costs and the amount due to Carter's. The discounts were reported in a contra-revenue account and as a reduction in the receivable due from the customer. Discounts were negotiated between the supplier and retailer and were often not finalized until just before or after the end of a fiscal period (SEC, 2012).

To increase Carter's sales to Kohl's and maintain the mutually beneficial relationship, Elles granted higher discounts than Carter's authorized. Normally Kohl's would not take these excess discounts, however, until the following accounting period. This delay prevented Carter's management from learning of the additional discounts allowed Kohl's. Accordingly, the accommodations were recorded by Carter's in the period when Kohl's paid for the merchandise. Anyway, why should Johnson, a Kohl's employee, be concerned as to when Carter's recognized the discount?

Carter's accounting department monitored the amount of discounts given to its customers. When Elles granted a discount, his assistant "filled out an Internal Authorization Form (IAF) which set forth the details of each accommodation" (SEC, 2012). The assistant sent these forms to the executive who was responsible for budgeting discounts. After approving the IAF, the forms were sent to the accounting department. When the customer deducted the discount from its payment, Carter's accounting personnel checked to see if the discount taken agreed with the IAF. For approximately the first three years in which Kohl's received an additional accommodation, the discount was not in excess of the IAF because the extra accommodation was delayed until the following fiscal period. However, as Kohl's purchases and the corresponding accommodations increased, the delay in taking the additional discount became more difficult to manage. Finally, the discount that Kohl's took one year was much greater than what appeared on the IAF. When questioned about this discrepancy, Elles responded that Kohl's received an additional discount based on anticipated purchases. Management accepted this explanation, but requested that Elles obtain a letter of representation from Kohl's verifying the anticipated purchases and the amount of discount. The letter correctly stated the anticipated purchases, but understated the discounts by \$4.4 million.

The accurate accounting for inventories was essential for both Carter's and Kohl's. Carter's inventory typically comprised more than 40% of its current assets and 22% of its total assets. The cost of goods sold was approximately 63% of its total expenses (Carter's, 2015). Kohl's cost of goods sold also was about 63% of its total expenses. Inventory, however, usually was roughly 68% of its current assets and 25% of its total assets (Kohl's, 2014). Utilizing the perpetual inventory method of accounting, Kohl's increased its inventory account when it purchased merchandise from Carter's. Carter's recorded this sale to Kohl's by decreasing its inventory account and increasing their cost of goods sold account for the cost of the inventory. Carter's also recorded an accounts receivable due from Kohl's and the related sales revenue. Kohl's made similar entries as Carter's when merchandise was sold to its customers. The accounting for the accommodations, however, presented a problem in that the amount often was not settled until

after the end of the fiscal year. The amount of the accommodation or discount reduced Kohl's inventory cost and consequently its cost of goods sold. For Carter's, the accommodations granted reduced its accounts receivable from Kohl's and also was reported in a contra-revenue account, which reduced net revenue and net income. To comply with generally accepted accounting principles (GAAP), the discounts must be recorded in the same period as when Kohl's purchases from Carter's were made.

The relationship between Kohl's and Carter's had been beneficial to both organizations. Johnson valued Kohl's relationship with Carter's and the discounts that Kohl's was receiving since it increased the profitability of Kohl's, particularly its Children's Division. The letter that Elles asked Johnson to sign did not affect Kohl's financial statements. As Elles explained, the letter pertained to budget issues at Carter's (Hornbeck, 2012). In fact, Kohl's accounting department was probably not even aware that the letter existed. What harm could come from signing a letter from such a trusted supplier? Johnson also wished to show his appreciation for the generous discounts that Kohl's had received from Elles. Certainly, there was nothing illegal in delaying the additional discount amount until the following year. After all, what did it matter in which period Carter's gave the discounts to Kohl's?

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