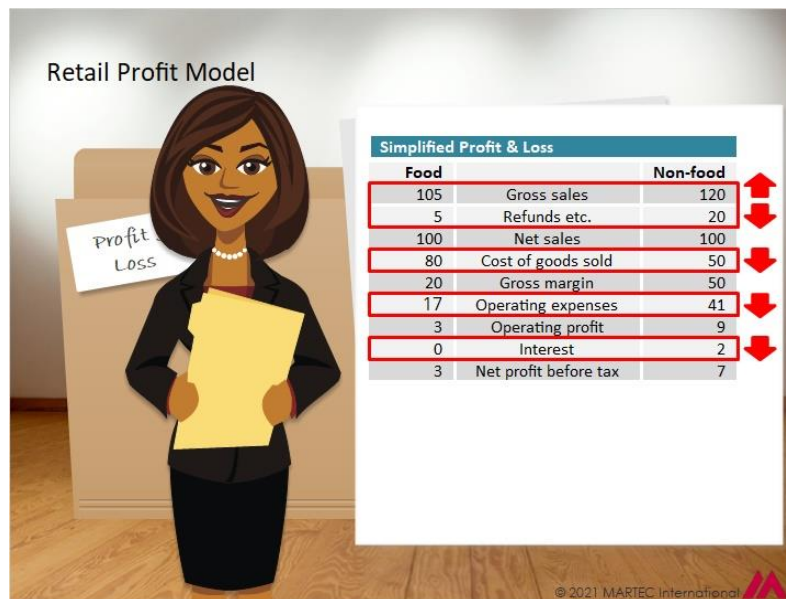


Introduction to Retail Financial Module Summary

Retail Profit and Loss Statement



There are four major ways a retailer can increase profits:

- Increase sales - either by increasing actual sales or reducing markdowns
- Reduce cost of goods - by improving sourcing, better negotiation and/or supply chain efficiencies
- Reduce expenses - through more automation and other types of efficiency improvement.
- Reduce interest charges through efficient use of inventory.

The biggest single expense in the expense category is labor, so investments that improve labor productivity are especially important.

Operating Expenses

The top 4 retail expense categories are shown in the chart below. IT expenses are included as a comparison.

The term “expenses” means all the costs of running the business excluding the cost of the merchandise.

Expenses include:

- Payroll of store, warehouse and headquarters personnel - this is the highest cost for most retailers and can vary from 8 to 14% of sales.
- The second highest is occupancy costs (i.e.; rent, heat, light, air conditioning, maintenance) - these are 8 to 10% of sales.
- In third place is usually warehousing and distribution costs averaging 4% of sales.
- Advertising and marketing costs are usually 3 to 6% of sales and can be the third largest cost if the retailer is very promotion driven.
- Information technology costs are quite low compared to other costs and vary from 0.5% to 1.8% of sales in brick and mortar retailers and up to 3% sales in online retailers.

And there are a variety of other expense categories, such as HR costs, finance costs, etc. Expenses are measured in money and are often also spoken of as a percentage to net sales. In each retail segment there are established percentage yardsticks for the major expense items.

Operating Expenses

Rank	Cost	Low (Discount Food)	High (High end dept store)
1	Store labor	8% Sales	14% Sales
2	Occupancy cost	8%	10%
3	Distribution	4%	4%
4	Marketing (advertising)	3%	6%
12?	IT	0.5%	1.8%

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Balance Sheet ABC Ltd. January 31st

	Assets	
Current Assets:		
Cash	\$2,000	
Receivables	3,500	
Stock	8,000	
Work in progress	500	
Total current assets		\$14,000
<i>You focus on stock reduction and cash generation</i>		
Fixed Assets:		
Property	\$16,000	
Fixtures & Fittings	4,000	
Total fixed assets		\$20,000
Total assets		\$34,000
<i>You focus on yield of fixed assets</i>		

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The Balance Sheet

The balance sheet is a financial accounting document. It summarizes a retailer's financial position at a given point in time. Most commonly, the balance sheet shows the financial position at the year end.

The balance sheet gets its name because the two sides of this expression must be equal.

$$\text{Assets} - \text{Liabilities} = \text{Equity} + \text{Retained profits}$$



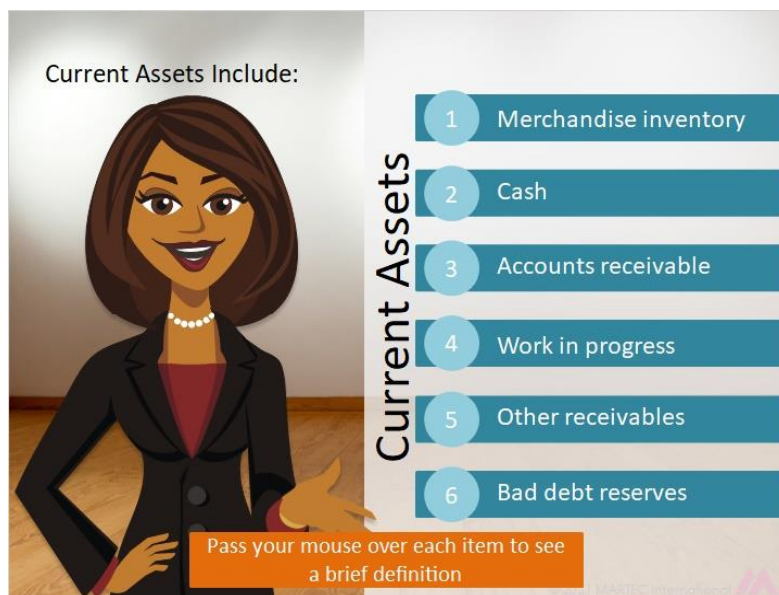
Put another way, one half of the balance sheet explains the money invested in the business, such as retained profits and investor equity. The other half shows how that money is being used. **This example** shows the half presenting how the invested money is used.

Assets are things like merchandise or store fixtures, owned by the company. Liabilities are the company's debts, such as payments due to suppliers for merchandise.

The balance sheet is drawn up at the most favorable time of the year for retailers. Most retailers end their fiscal year on January 31st, because the Christmas peak and January sales have dramatically reduced their inventory levels and therefore reduced the cost of year-end inventory counting.

When reviewing a retailer's inventory position at year end, remember that in some retail segments, such as fashion, their average inventory through the year would have been much higher. In fashion for example, the average inventory could have been 50%- 60% higher.

Current Assets



Current assets are cash and things that can be turned into cash within one year.

For a typical retailer, current assets are made up of:

- Merchandise Inventory - normally the biggest current asset on the retailer's balance sheet, because without inventory there are no sales. Inventory is normally stated at the lower of cost or market value. Many segments, such as department stores, often discuss the value of inventory at retail, not cost, in their management reporting. (Never in public financial reporting).
- Cash and Other Current Assets are made up of cash on hand, bank accounts to which the retailer has immediate access, marketable securities and prepaid expenses. The cash is used to buy further inventory and surplus cash may be invested in overnight money markets. When inventory is sold the cash can be recycled directly into fresh inventory.
- Accounts Receivable - money due from selling merchandise on credit. This includes private label credit cards, layaway and deferred billing accounts. For a department store, the accounts receivable

as a percentage of sales will always be higher than, for example, a grocery store, at which most customers pay by cash, debit cards or 3rd party credit cards for their transactions. From a marketing viewpoint, in house credit is important for customer service, customer loyalty and the chance to target market to these consumers.

- Work in progress - the deposit on made to measure curtains that have not been finished yet.
- Other Receivables may include: leased department receivables, amounts due from cosmetic and other demonstrators, money due from merchandise returns to vendors, volume allowances and advertising rebates.
- Bad Debt Reserves - Retailers financing their own customer credit will always make some allowance for bad debts. Where retailers run their own in-house credit, they usually have collections departments. Sometimes they sell the bad debt accounts to outside collection agencies.

Fixed Assets

Fixed assets are assets that require more than a year to convert into cash.

In retailing, these are usually:

- Buildings, if owned rather than leased
- Fixtures, such as display racks
- Equipment, such as trucks
- Long term investments such as real estate

Most fixed assets have a limited useful life; the value of these assets should be less over time, and they are depreciated accordingly. Asset depreciation will vary with the asset. For example, buildings may be depreciated over 20 to 30 years, display fixtures depreciated over 5 years, and carpets over 3 years. Most PCs are depreciated over two years, mid-range servers over three years and mainframe class machines over five years. POS registers may be depreciated over 3 to 5 years.

Liabilities

Liabilities, like assets, are divided into current and long-term. Current liabilities are debts that are expected to be paid in less than a year.





The key current liabilities are:

- Accounts Payable - this is money owed to suppliers, mainly for merchandise. Retailers purchase inventory on credit from suppliers. The longer the period of time they have to pay suppliers, the larger the accounts payable. However - a long period also means they don't have to borrow so much to finance the inventory, as they will have sold more of it before payment is due.
- Other types of accounts payable are what are owed to suppliers for office supplies and store operating expenses, such as bags, stationery and wrapping supplies.
- Notes Payable is the interest the retailer has to pay on loans due and payable within a year.
- Accrued Liabilities means taxes, payroll and selling commissions, rent, utilities, sales taxes and other debts, which have not yet been paid. They are called 'accrued' as they normally grow daily but are paid at the end of the month or agreed period.
- Long-term liabilities are debts that are paid after one year. Examples of these liabilities are bonds and mortgages on real estate.
- Customer Liabilities include customer-related items such as unredeemed gift certificates, customer advanced deposit payments and mail order deposits.

Equity and Retained Profits

Equity and retained profits are the investments made by the shareholders plus the value of retained profits from earlier years.

- Equity is the issued shares in the company and any additional paid-in capital.
- Retained Profits are the accumulated profits that have not been paid out in dividends to owners. The decision on how much is distributed to shareholders and how much is retained profits tends to be related to the corporation's potential growth. For example, a high growth retailer will retain most of its earnings so it can finance new stores, inventory and expenses

Building Retail Sales and Profitability



This chart shows a well-known formula for calculating sales and improving them. Sales is the number of people that come into the store (the traffic) times the percentage that make a purchase (which is the conversion rate) times the average size of their purchase (transaction size or basket size). To grow sales you need to:

- Increase the number of people that come in.
- Increase the conversion rate.
- Increase the transaction size.

For an online retailer, the formula would be extended by subtracting returns from the sales total. Minimizing returns is an important activity. In online retail, returns average 30% of sales, while in conventional stores the return rate is very much lower (low single digits).

Retail Enjoys Favorable Cash Flows

Retailing enjoys better cash flow than many industries because the customer often pays for the goods before the retailer has to pay the supplier. Let's take an example of how this works.

Imagine you have a supermarket business that turns its inventory every month (30 days). Put simply, it means that if you buy a truck load of inventory from a supplier, you sell it all in 30 days. If you pay the supplier on 30 days, you pay for the goods when you have sold them all. During that month though, your

average cash position is equivalent to half a truckload of value at retail price. You have that much cash until you have to pay for the goods and pay your expenses, such as your monthly payroll. Hence your cash position is very good. But it can get better.

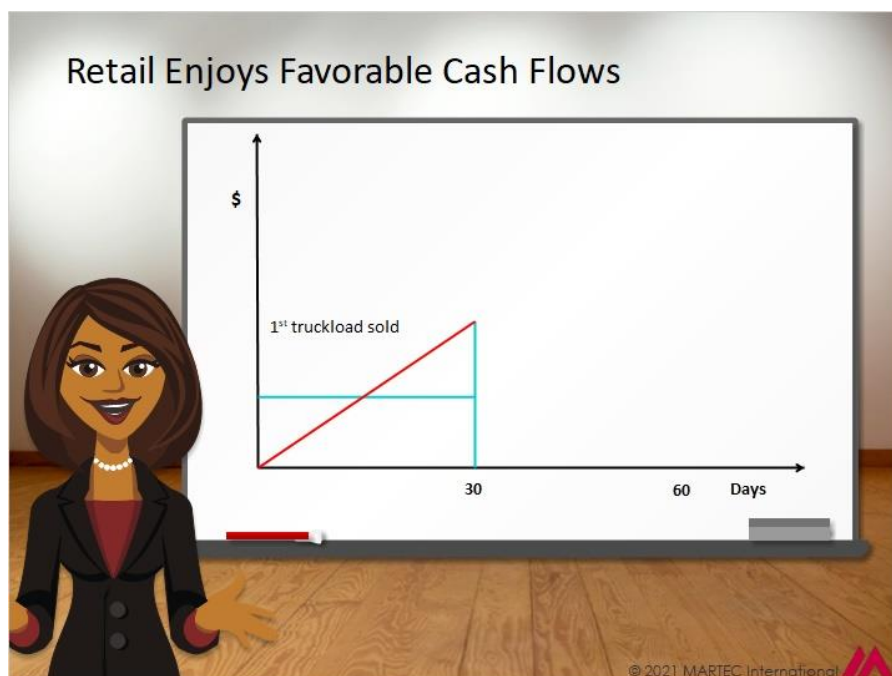
Suppose you negotiate 60-day payment terms with your supplier. In 60 days you sell two truckloads. In month one you have half a truckload of cash. In month two you have all the cash from the first truckload minus operating expenses you have had to pay, plus an average of half a truckload from month two. In other words, you have the gross margin from month one and half a truckload equivalent from month 2.

Hence retailers have very good cash flow compared to other industries. The question becomes what to do with the money? In the short term it is invested in the overnight money markets where it can earn some interest. Some retailers in the UK also become banks like Sainsbury and Marks and Spencer (usually as joint ventures with banking houses). They can lend the money they don't need now to customers at much better interest rates than they can earn on deposit. They can also invest it on store refurbishments, opening new stores, etc.

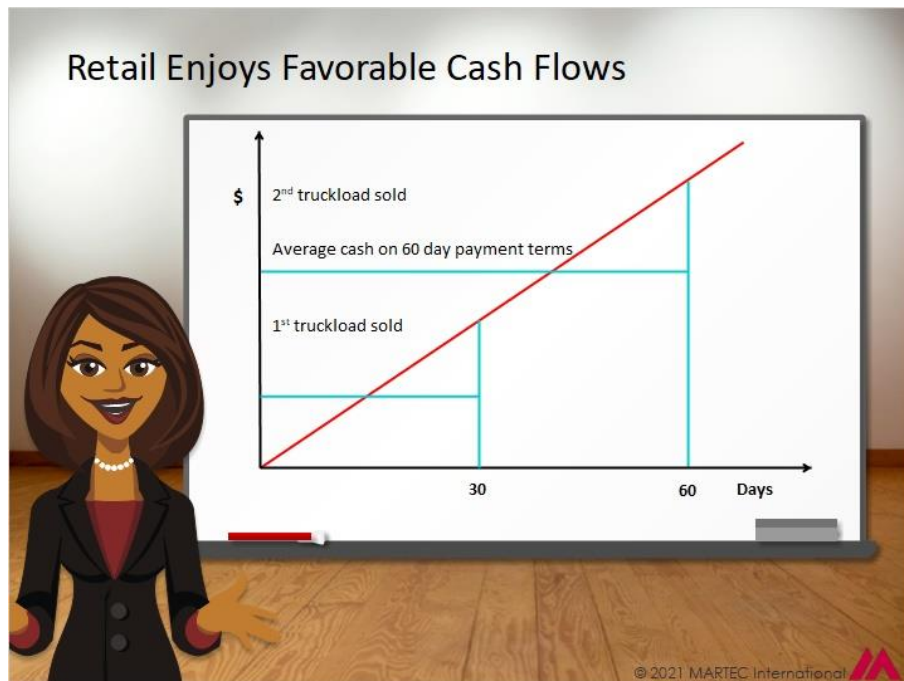
Retailers generally negotiate deals with suppliers to say, for example, that we will pay you on 60 days, however, at our discretion we may choose to pay you on 7 days and take an extra 5% discount. When they have plenty of spare cash, they pay those suppliers that agreed to these terms early and take the discount, as this is more valuable than what can be earned on overnight deposit.

One of the reasons that so much retail is owned by private equity companies is that the very favorable cash flow can pay the interest payments on the leveraged debt that private equity investors often use to buy businesses.

At The End of Month 1



At The End of Month 2



Balancing Gross Margin, Inventory Turn and Payment Terms

Not every retail segment is as fortunate as supermarkets in respect of inventory turn. Hence it is important to profitability and long-term success to get the right balance between 3 factors:

- Gross margin
- Inventory turn
- Payment terms.

For example, supermarkets have inventory turns of 10 a year in the US and 15 in the UK (unless they sell clothing as well). With 60 day payment terms they are in a very good cash position and earning interest rather than paying it. Therefore they can support a more aggressive gross margin.

A jeweler might do 1.1 to 1.2 inventory turns a year and pay its suppliers on 90 days. Hence the jeweler has to pay interest costs financing his inventory, for the average 8 months between paying the supplier and selling the item. In this case, the jeweler needs to make a big gross margin in order to absorb the extra costs. Getting these relationships wrong can be very costly.