

SECTION 2: Manipulating Profit Variables: Merchandising for a Profit

Part 3: Expanded Profit and Loss Statement: Calculating the P & L Components

Part 3: 3-2 Reductions

Reductions are a decrease or lowering in the price and/or value of an item; depreciation of goods; amount deducted from the current retail price; or the loss of inventory. Reductions are unavoidable in the operations of a retail store however they must be monitored and controlled since a change in retail price most likely will impact the bottom line of the retailer. For example, an increase in reductions greatly impacts net sales and can trickle down to cause a decrease in gross margin and subsequently reduce profit.

Reductions on the expanded P & L Statement include: a) customer returns and allowances, b) employee discounts, c) markdowns, and d) shrinkage. Policies and procedures must be set by individual retailers for controlling each of these reductions.

For example, one cause of shrinkage -- both employee theft and customer shoplifting -- must be monitored in order to assure that employees are following guidelines for preventing theft of merchandise. In the case of employee purchases, regulations must be in place for the process of making purchases during the workday, storage of those purchases while working, and procedures for removing the purchased goods from the store. Employee pilferage can cost the retailer thousands of dollars annually if an employee devises a scheme to take merchandise from the store without paying the full amount due or does not pay for the merchandise at all.

The amount of customer returns and allowances vary among store types as well as the policies and procedures for returning goods to those stores. **Customer returns**, either 100% refunds or partial refunds are deductions in retail price, most often given back by the retailer to the consumer, after the sales transaction has been recorded. **Customer allowances** or partial retail reductions are made by the retailer for soiled, damaged or poor quality merchandise in order to entice the customer to make the purchase of the item in its current condition. This purchase saves the retailer time and money since the goods are not required to be processed and returned to the vendor, or the retailer does not have to take a deeper markdown in order to sell the damaged goods.

Customer returns and allowances are a part of doing business for the retailer. There are many reasons for customer returns. The merchandise might not be the right color or size, or the item might not be appropriate for the customer's wardrobe or for the occasion of wearing or the appliance, furniture or home accessory might not match with the customer's current home décor, or it may be too large or small for a room. In order to build a loyal customer following, many retailers maintain lenient policies for returns in order to entice customers to purchase from their stores. If a consumer is aware that an item can be returned without a hassle or without going through a lengthy amount of time for the return to be processed, that customer will more than likely shop with that same retailer again.

Employee discounts are reductions in retail price on goods given by the retailer in order to show appreciation for the work of those employees and to entice the employees to buy merchandise from the employer. Some retailers consider employee discounts as a benefit to both the employee and employer. The employees are likely to purchase larger quantities of merchandise at the reduced prices thus they are happy about the savings. Additionally, these employees feel as if they are an integral part of the business and take pride in their work, becoming loyal employees.

Many times the employees are required to wear the merchandise to work, or use the product in order to become familiar with the merchandise, its features, benefits and quality. When wearing or using the product, the employees gain knowledge and expertise about the merchandise they can then utilize this knowledge to sell product to the store's consumer. The employees also can become a walking marketing medium for advertising the store. Therefore, the retailer benefits by retaining happy, trained employees who possess knowledge and expertise for selling and advertising the product.

And, as discussed earlier in **Section 1, Part 4: 4-1 – 4-5, Effective Markdown Techniques: Planning Markdowns**, **markdowns** are defined as a reduction in the selling price or a reflection of the depreciation in the value of the merchandise. Markdowns are a fact of life for the retailer and can be either a setback or a useful merchandising tool. Therefore, it behooves the retailer to use markdowns as a guide to operate a profitable business.

There are three primary reasons for markdowns: those used to correct buyer error, those employed for managerial operational devices, or others utilized as merchandising devices. (See **Section 1** for detailed information on these types of markdowns.) Buyers must take risks when planning and procuring merchandise. Additionally, buyers cannot control external environmental factors (e.g., economy, weather, consumer spending patterns) that impact sales, nor can they influence a change in happenings such as legislation or politics over which they have no control. Therefore, some of the merchandise purchased, even by an experienced, astute buyer, is always reduced.

Management may decide to mark down merchandise in order to foster more efficient or timely store operations. Pricing errors can occur and the price must be lowered to meet the price of the competition or the price that the market demands. Oftentimes, merchandise is leftover merchandise from a major selling season. These odd lots and broken sizes must be reduced in order to make space for more saleable product or to create cash flow.

Many times merchandising errors require markdowns. Merchandise that is incorrectly housed or not displayed appropriately must be marked down due to lack of customer recognition and ultimately demand or merchandise that is not promoted in a timely manner before the peak selling season, especially fashion goods, may need to be marked down in order to entice the consumer to make a purchase. Obsolescence of a fashion trend or product design oftentimes calls for a deep cut in the initial retail price of an item. Additionally, promotional markdowns may be used as a major merchandising tool. Review in **Section 1**.

Regardless of the type or source of the markdown, markdowns must be controlled to improve the financial performance of the retailer. The experienced buyer must control risks through well-planned purchases and development of appropriate marketing and effective merchandising techniques. Planned policies and procedures are a necessity to guide the controlled management of markdowns.

Shrinkage or shortage of merchandise must be taken into consideration when recording reductions. **Shrinkage** is the difference between an actual physical inventory count and the amount of merchandise recorded on the book or paper inventory. There is an **overage** of inventory when the physical inventory is larger than the book inventory. There is a **shortage** of inventory if the book inventory exceeds the physical inventory. Neither of the above scenarios is ideal for the retailer. Retailers now use computers to track inventory; however, some shortages are not unusual due not only to pilferage and shoplifting,

but also to paper errors in counting and calculating markdowns, and errors made when paying invoices or recording sales transactions. An acceptable shortage for a retailer is usually 2 % - 3 % of net sales.

All of these reductions are entered as a line item on the expanded P & L Statement. They are subtracted from gross sales to determine the amount of net sales. Formulas for calculating reductions on the expanded P & L Statement are below:

$$\text{Reduction \$} = \text{Customer Returns \& Allowances} + \text{Employee Discounts} + \text{Markdowns} + \text{Shrinkage}$$

$$\text{Reduction \$} = \text{Net Sales \$} \times \text{Reduction \%}$$

$$\text{Reduction \%} = \text{Reduction \$} \div \text{Net Sales \$}$$

Problem: Using the figures provided, calculate reduction dollars and reduction percent.

Example Figures for Calculating the Expanded P & L Statement

Customer Returns & Allowances = \$15,000.00	Gross Sales = \$372,000.00
Employee Discounts = \$3,000.00	Net Sales = \$300,000.00
Markdowns = \$45,000.00	Gross Margin = \$139,500.00
Shrinkage = \$9,000.00	Contribution Margin = \$111,000.00
Invoice Cost of Goods = \$161,500.00	Maintained Markup = \$133,500.00
Transportation = \$5,000.00	Alterations \$3,000.00
Direct Operating Expenses = \$28,500.00	Cash Discounts = \$9,000.00
Indirect Operating Expenses = \$87,000.00	(Net) Operating Profit = \$24,000.00

$$\text{Reduction \$} = \text{Customer Returns \& Allowances} + \text{Employee Discounts} + \text{Markdowns} + \text{Shrinkage}$$

$$\text{Reduction \$} = \$15,000.00 + \$3,000.00 + \$45,000.00 + \$9,000.00$$

$$\text{Reduction \$} = \$72,000.00$$

$$\text{Reduction \$} = \text{Net Sales \$} \times \text{Reduction \%}$$

$$\text{Reduction \$} = \$300,000.00 \times 24.00 \% (.24)$$

$$\text{Reduction \$} = \$72,000.00$$

$$\text{Reduction \%} = \text{Reduction \$} \div \text{Net Sales \$}$$

$$\text{Reduction \%} = \$72,000.00 \div \$300,000.00$$

$$\text{Reduction \%} = 24.00 \%$$

The format for calculating the Expanded P & L Statement is exactly like the spreadsheet for the Skeletal P & L Statement, except additional lines are added for the expanded information. The beginning of the Expanded P & L Statement is reviewed below:

Component	Dollars (\$)	Percent (%)
Gross Sales	\$372,000.00	124.00%
- Customer Returns	\$15,000.00	5.00%
- Employee Discounts	\$3,000.00	1.00%
- Markdowns	\$45,000.00	15.00%
- Shrinkage	\$9,000.00	3.00%
= Net Sales	\$300,000.00	100.00%

In *Part 3: 3-3 Total Costs of Goods Sold* will be explored and formulas will be provided for new calculations in order to expand the subcomponents of Total Costs of Goods Sold. These subcomponents will also be formatted on the expanded P & L Statement spreadsheet.