

## **SECTION 2: Manipulating Profit Variables: Merchandising for a Profit**

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

#### *Part 3: 3-3 Total Costs of Goods Sold*

The **cost of goods sold** are also known as the **invoiced cost of merchandise**, the **wholesale cost of goods** or the **billed gross wholesale cost of goods**. Cost of goods includes the cost of goods on the beginning inventory plus the cost of goods purchased during a specific period of time. When placing an order during a market trip or writing a reorder to replenish quick selling merchandise, the buyer frequently tries to negotiate with the vendor in order to obtain a lower wholesale cost on the merchandise. Some manufacturers establish the wholesale cost and do not negotiate for lower prices on their goods until the end of their shipping season. Others do not negotiate at all. For example, many designer and national branded apparel companies do not negotiate wholesale costs of goods since they have established a status image, marketing their product based on quality, price and brand equity. Also, these companies may sell several retailers who are located closely within a specific geographic area. Therefore, since reduction in price will impact the image of the product, they do not want the merchandise to be discounted or sold off-price during the peak selling season.

As previously discussed, besides the wholesale cost of goods, the **total cost of goods sold** includes the following elements:

- Invoiced, wholesale or billed gross wholesale cost of merchandise or goods
- Transportation or shipping costs (including insurance when applicable)
- Discounts and
- Alterations (when applicable).

**Transportation** or shipping costs are included on the invoice from the vendor. These charges can be negotiated however it is common in today's marketplace for the vendor to pay the shipping cost and insurance (if applicable), covering goods during the shipping process from the vendor's loading dock to the retailers loading dock. The retailer then will reimburse the vendor for these costs. Thus the costs are added to the retailer's cost of goods sold and are included on the invoice.

The terminology used in retail to describe the type of transportation negotiated by the buyer is *FOB* or *free on board*. More specifically, the type of terms determines the location of when and where the title of the goods passes from the vendor to the retailer. With the above transportation type, the terms of shipping, written on the order copy, is *FOB store charges reversal*. Therefore the title to the goods belongs to the vendor until the goods reach the loading dock of the retailer. As soon as the retailer's receiving room personnel signs the shipping documents, the title of goods passes to the retailer. Shipping costs have become very expensive due to the state of the economy, reflecting the international sourcing policy of the majority of companies and an increase in fuel expenses.

A **discount** is a reduction in cost of the wholesale price, offered to the retailer by the vendor. In some segments of the apparel industry, there are standard discounts. In others, discounts may be negotiated as the cost of doing business with that particular vendor. The three major types of discounts include: a) cash, b) quantity, and c) trade. Not all vendors offer all of these discounts as vendors must consider the type of discounts the company wishes to offer before determining the wholesale cost of their merchandise.

In the ladies or women's apparel industry as well as in accessories and many children's companies, cash discounts are standardized and now expected by the retail buyer. A **cash discount** is a percent reduction on the wholesale cost of goods if the retailer pays the invoice within the time period specified on the vendor's invoice and the store's order copy. Therefore, a buyer never turns in an order to the vendor or "leaves paper" without specific terms written on the order copy. The same terms are then specified on the *vendor's order acknowledgement* (i.e., vendor's written acceptance of the retail buyer's order) as well as on the vendor's invoice.

*Terms* include both cash discount percent amount and dating or time limits in which the retailer must pay the invoice. *Dating for payment* is based on the date of the invoice, which is more than likely the date on which the merchandise is shipped from the vendor's distribution center.

The standard terms for ladies or women's apparel is *8/10 EOM*. The retailer may deduct 8 % from the wholesale cost of the merchandise if the invoice is paid within 10 days from the end of the month (EOM) in which the invoice is dated.

For example, if the invoice is dated from the first of the month to the twenty fifth of the month, the invoice is paid on the tenth day of the next month. However, if the invoice is dated from the 26<sup>th</sup> to the 31<sup>st</sup> of the month the retailer has an extra month to pay. Essentially, he may pay the invoice two months from the date of the invoice, on the 10<sup>th</sup> day of that month. Thus, the retailer has extra time to sell the merchandise before the bill is due for payment. The retailer never receives any cash from the vendor but deducts the 8 % from the wholesale cost of goods. This deduction cannot be made on transportation and insurance, only on the merchandise cost. This discount is considered as hidden profit for the retailer and is a line item on the expanded P & L Statement.

An example of *cash discounts* is illustrated below:

A cotton sweater with a wholesale cost of \$25.00 and terms of 8/10 EOM was purchased by the retail buyer in the missy sportswear department. The sweater was shipped on October 10 and was received in the store on October 30. The invoice is dated October 10. What is the amount to be remitted for the invoice and when must the invoice be paid in order for the retailer to take the 8 % discount?

**Problem:**

$$\begin{aligned} \text{Wholesale cost} &= \$25.00 \\ \text{Cash Discount} &= 8 \% \\ \text{Wholesale cost to be remitted} &= \$25.00 \times 8 \% (.08) \\ &= \$2.00 \\ \text{Amount remitted on invoice} &= \$25.00 - \$2.00 \\ &= \$23.00 \end{aligned}$$

**However, the invoice must be paid by November 10 (10 days from the end of the month in which the invoice is dated) in order for the retailer to take the 8 % discount. If the invoice was dated October 30, the retailer would be allowed to pay the invoice on December 10 without any penalty.**

Another type of discount is the quantity discount. A **quantity discount** is allowed if the retailer buys a specified quantity of an item or a specific quantity of purchases over a specified period of time. Usually the larger the quantity purchased by the retailer, the larger the discount offered by the vendor. Sometimes vendors produce items in dozens and prepack the garments. For example, the dozen may

have only one color of the item and may be prepacked with two smalls, four mediums, three larges and three extra larges. This vendor offers a package of 25 prepacks of men's cotton tees at a substantial quantity discount cost. Retailers with multiple stores can take advantage of this packing as they can divide the tees by style, color and size based on the geodemographic method of matching style, color and size to a specific location for that particular target consumer.

For example, the 25 prepacks of men's cotton tees, costing \$60.00 *per dozen* may be purchased with a quantity discount of 10 %.

**Problem:**

$$\begin{aligned}\text{Wholesale cost} &= \$60.00 \text{ per prepack of dozen} \\ &= \$60.00 \times 25 \text{ prepacks} \\ &= \$1,500.00 \\ \text{Quantity Discount} &= 10 \% \\ \text{Wholesale cost to be remitted} &= \$1,500.00 \times 10 \% (.10) \\ &= \$150.00 \\ \text{Amount remitted on invoice} &= \$1,500.00 - \$150.00 \\ \text{Amount remitted on invoice} &= \$1,350.00\end{aligned}$$

Quantity discounts are deducted by the vendor before the invoice is submitted to the retailer, are made before any other discounts are taken, and are deducted regardless of payment due date of the invoice. Sometimes these discounts are known as *patronage discounts* since they are used by the vendor to entice the retailer to buy larger quantities or to return to the vendor when making similar purchases.

Lastly, **trade discounts** are based on the list price or the suggested retail price of the vendor for the merchandise. (However, vendors may not legally require the retailer to retail an item at a specific or suggested retail price.) The list price or suggested retail price of the vendor is higher than the price for which the retailer plans to sell the merchandise. Trade discounts are usually quoted as a series of discounts. For example, a cotton blouse may have a list price in the wholesaler's catalog of \$75.00 with discounts of 30 % and 10 %. These discounts cannot be added, but must be calculated and deducted separately from the list price or each discount must be taken separately in the sequence as listed and must be taken from the previous amount.

For example, the retailer purchases the \$75.00 dollar cotton blouse with trade discounts of 30 % and 10 %. What is the wholesale cost of the product?

**Problem:**

$$\begin{aligned}\text{List Price} &= \$75.00 \\ \text{Trade Discounts} &= 30 \% \text{ and } 10 \% \\ \\ \text{List Price Less } 30 \% &= \$75.00 \times 30 \% (.30) \\ &= \$22.50 \\ \\ \text{Wholesale Cost} &= \$75.00 - \$22.50 \\ &= \$52.50 \\ \\ \text{Less } 10 \% &= \$52.50 \times 10 \% (.10) \\ &= \$5.25\end{aligned}$$

### Wholesale Cost = \$47.25

Trade discounts are also known as *functional discounts* since the discounts are based on the channel of distribution in which the company operates. For example, the retailer might receive less discounts than an interior designer who offers the client different services. Trade discounts are deducted upfront before the retailer receives the invoice.

In summary, all retailers take advantage of negotiating for terms or discounts and dating. However, different segments of the industry offer different types of discounts based on the channel of distribution, merchandise type and zone in which the merchandise is marketed.

Another cost that the retailer may incur is that of alterations. **Alterations** or preparing merchandise for proper fit for a specified consumer in order to sell the item is a cost that the retailer must consider. Since alterations are costly, many retailers no longer offer this service as a free service. However, there are exceptions. Most menswear stores are expected to provide this as a free service, since many items arrive from the manufacturer without finished pant hems or finished sleeve lengths and must be fitted to the specifications of the consumer in order to complete the sale. Moreover, many stores are now selective on policies to cover the cost of the alterations. Some alterations are free while others are paid for by the consumer. If the consumer pays for the alterations, the retailer does not add those costs to the cost of goods sold.

Along with alterations, some retailers include in the calculation of cost of goods sold **workroom costs** or costs for preparing the merchandise for presentation on the sales floor. (Usually, the workroom costs do not include receiving costs such as ticketing and or hanging goods for the sales floor.) Also, **returns to vendor** for defective or poor quality goods, orders shipped after order *cancelation dates* or late deliveries as well as merchandise shipped incorrectly or not ordered by the retailer are subtracted from the invoice.

From the above discussion, it is evident why it is most important for the retailer to track all expenses related to cost of goods sold. Total cost consists of various subcomponents that add additional costs rather than only the cost of the merchandise itself. It is imperative that buyers take advantage of discounts, negotiate shipping costs, and sometimes even passing on the cost of alterations to the consumer.

The following formula is needed to calculate total cost of goods sold:

$$\text{Cost of Goods Sold \$} = \text{Invoice Cost \$} + \text{Transportation \$ (including insurance)} \\ + \text{Alterations \$} - \text{Cash Discount \$}$$

**Problem: Using the figures in Part 3: 3-1 of this Section, calculate cost of goods sold dollars.**

$$\text{Cost of Goods Sold \$} = \text{Invoice Cost \$} + \text{Transportation \$ (including insurance)} \\ + \text{Alterations \$} - \text{Cash Discount \$} \\ \text{Cost of Goods Sold \$} = \$161,500.00 + \$5,000.00 + \$3,000.00 - \$9,000.00 \\ \text{Cost of Goods Sold \$} = \$160,500.00$$

**(Note: On the expanded P & L Statement, percents are calculated for each subcomponent as well as total cost of goods sold.)**

All of the subcomponents of the cost of goods sold are a line entry on the expanded P & L Statement. A review of the total cost of goods sold may be reviewed on the following page.

**Expanded P & L Statement**

| <b>Component</b>           | <b>Dollars (\$)</b> | <b>Percent (%)</b> |
|----------------------------|---------------------|--------------------|
| <b>Gross Sales</b>         | <b>\$372,000.00</b> | <b>124.00%</b>     |
| - 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%              |
| <b>= Net Sales</b>         | <b>\$300,000.00</b> | <b>100.00%</b>     |
| - Invoice Cost of Goods    | \$161,500.00        | 53.83%             |
| - Transportation           | \$5,000.00          | 1.67%              |
| <b>= Maintained Markup</b> | <b>\$133,500.00</b> | <b>44.50%</b>      |
| - Alterations              | \$3,000.00          | 1.00%              |
| + Cash Discounts           | \$9,000.00          | 3.00%              |
| <b>= Gross Margin</b>      | <b>\$139,00.00</b>  | <b>46.50%</b>      |

Note: The amount of cash discounts in the above expanded P & L Statement significantly impacts the gross margin amount and ultimately the profit of the store.

In the next segments of *Part 3*, Maintained Markup and Gross Margin with Operating Expenses will be reviewed before Contribution Margin and its impact is explained.