



CLASS NOTES

Multi-Step Income Statement Merchandising Operations - 1 of 5

The bottom line of any income statement tells you if your business made a profit or a loss. The “Multi-Step” income statement tells you much more. It is an important managing tool. These Class Notes take a magnifying glass to each section of the multi-step income statement to explain - **managing by the numbers**.

Go to the Class Notes Index –“The completed Multi-Step Income Statement,” and print it as you read these Notes

Section 1 – Sales & Net Sales

The difference between Sales and Net Sales is about subtracting the total of two categories of transactions from Sales:

- Sales discounts
- Sales Returns and Allowances

These two accounts are called **contra accounts** – because they are Debit balances, opposite to Sales which is a Credit balance. See the Class Notes for further detail.

Statement Presentation – It Looks Like This

When preparing a Multi-Step Income Statement, **ALWAYS** make 4 columns.

Sales **ALWAYS** go in column 4; Sales Discounts and Sales Returns & Allowances **ALWAYS** go separately in column 3. Like this:

	1	2	3	4
Sales				100
Less:				
Sales Returns & Allowances			8	
Sales Discounts			<u>9</u>	
Net Sales				<u>17</u> 83

Question: In this example Returns & Allowances are 8% and discounts are 9%. **Is this good, bad or ugly?**

Multi-Step Income Statement Merchandising Operation; Sales & Net Sales continued... 2 of 5

Managing - Sales & Net Sales - By the Numbers

Answer: It depends what the business reactive tolerance policy is for Sales Returns & Allowances. **All businesses have the objective of ZERO Returns & Allowances.** Clothing retailers have a higher tolerance percentage than automotive retailers. Automotive retailers have a higher tolerance percentage than commercial aircraft companies.

An exaggerated example would be where Sales are \$100; and Net Sales are \$45

If you were the owner of this company, or a shareholder, you would be very concerned - why 55% of sales are being returned or allowances given for - the numbers are screaming, "There's a big problem here!"

Section 2 – Net Sales & Gross Profit - e.g. “on the Bananas”

The difference between Net Sales and COGS (Cost of Goods Sold - see Class Notes) is Gross Profit. Gross Profit tells you how much profit was made just on the difference between what you paid for the bananas and what you sold them for. There are other operating expenses such as rent, advertising insurance, utilities and so on; but these are outside the direct cost of the bananas.

It is critical to know how much profit was made, just on the bananas as a percentage. This is called the Gross Profit Percentage. It is calculated like this:

$$\frac{\text{Gross Profit} \times 100}{\text{Net Sales}} = \text{GP\%}$$

Merchandisers know the GP% and the sales volume of every product in the store.

Statement Presentation – It Looks Like This

Net Sales and COGS **ALWAYS** go in column 4 to derive Gross Profit.

	1	2	3	4
Net Sales				500
Cost of Goods sold				<u>450</u>
Gross Profit	:			50

**In this example Gross Profit is 10%.
Question: Is this good, bad or ugly?**

Multi-Step Income Statement Merchandising Operations: Goss Profit continued... 3 of 5

Managing - Gross Profit - By The Numbers

Answer: It depends. If you are selling jewellery; it is not good at all. If you are selling bananas; it is very good.

The GP% drives decisions as to whether or not specific products are kept on hand for sale. Businesses consider what the GP% is for each product AND the sales volume of each product. Products that have a high sales volume usually have a lower GP% than slower moving usually higher priced goods. Products that move slowly and have a low GP% are soon rejected as bad for business.

Large retailers often manage by what is called a "hurdle rate." This means that when they consider a product to take up shelf space; it must have a GP% of X – say 25%. If the product is under this percentage, it is not worthwhile selling. On the other hand, items that have a low GP%, compared to other products taking up shelf space, often remain on the shelves because customers expect them to be there; such as bananas. These types of products are called "loss leaders." Loss leaders will be well advertised to get customers in the store.

Section 3 – Expenses

Examining net sales, gross profit and GP% are crucial to knowing what the income statement is communicating about the results of the business for a time period – month, quarter or year. Expenses are – more money spent in order to support generating revenue that relate only to the current accounting period being measured, but not directly to inventory. Typical expenses in a business:

- Advertising
- Bank charges
- Delivery (to customers)
- Depreciation
- Insurance
- IT and Internet
- Interest
- Marketing
- Office
- Rent
- Repairs
- Salaries and wages
- Supplies
- Telephone
- Utilities
- Vehicle running costs (fuel, repairs, insurance)

Multi-Step Income Statement **Merchandising Operation; Expenses** **continued... 4 of 5**

Statement Presentation -- It Looks Like This

Selling and Operating Expenses **ALWAYS** go in column 3 to derive Net Income.

	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>
Gross Profit				500
Selling Expense			150	
Operating Expense			<u>75</u>	
			Total expense	<u>225</u>
Net Income			:	<u>275</u>

Merchandise businesses generally categorize and group expenses as either “**Selling**” or “**Operating**.”

Selling expenses are expenditures made that are clearly related to the selling of the product – advertising, marketing, sales commissions, and deliveries to customers are examples. Other expenses such as rent, depreciation, telephone and utilities can be broken down to identify how much relates to the sales operation and how much relates to general operations.

Operating costs relate to all costs that **are clearly not** related to selling efforts. Administration, cleaning and maintenance costs are operating cost examples.

Why Bother Separating Selling & Operating Expenses?

The short answer is “**to manage by the numbers.**”

Selling expenses are tracked and compared month-by-month, quarter-by-quarter and year-by-year. These are then analyzed by each time period – this month versus last month; or quarter or year. Management looks at these numbers and asks:

- Why are selling expense up (or down) 10% this month (quarter, year) compared to last month (quarter, year)?
- What is causing the fluctuation?
- How can we reduce costs and increase sales next month?

Multi-Step Income Statement Merchandising Operation; Expenses continued... 5 of 5

Selling expenses are also analyzed as a percentage of Sales and as a percentage of total expense. Management looks at these and asks:

- Selling expense as a percentage of Sales is 12% this month (quarter, year) and last month (quarter, year) it was 8% - why is it up 50%? (Or down 33% if the period figures are reversed)
- Selling expense as a percentage of total expense is 60% this month (quarter, year) and last month (quarter, year) it was 50% - why is it up 20%? (Or down 17% if the period figures are reversed)
- How can we reduce costs and increase sales next month?

The explanation could relate to fluctuations in Net Sales; then again maybe not. Perhaps the sales commission rate has changed; maybe more advertising was done; maybe a dozen other factors.

Operating expenses are also analyzed in comparative format month-to-month, quarter-to-quarter and year-to-year in the same way as selling expense; with the same management questions.

Operating expenses are also analyzed as a percentage of total expense with the same management questions.

Managing by the Numbers – Critical Items

- Net Sales as a % of Sales
- Sales Returns & Allowances as a % of Sales
- COGS as a % of Net Sales
- Gross Profit as a % of Net Sales
- Operating expense as a % of Net Sales, and as a % of total expense
- Selling expense as a % of Net Sales, and as a % of total expense
- Net Income as a % of Net Sales