

SECTION 2: Manipulating Profit Variables: Merchandising for a Profit

Part 2: Skeletal Profit and Loss Statement: Calculating the P & L Components

Part 2: 2-5 Operating Expenses

Operating expenses is money needed for a business to function or operate on a daily basis. Cost of goods sold is not included in these expenses. Any business, regardless whether the organization is brick-and-mortar, online, or in another format, incurs costs while providing goods and services for the target consumer. Retailers identify these costs as **overhead** or the operating expenses for running the business.

A partial listing of operating expenses include management salaries, wages for employees, rent, building insurance, building maintenance, utilities, selling supplies, receiving and marking room costs, advertising, travel expenses, interest on debt, depreciation on fixtures, etc. Based on the type of the expense, the retailer may control or reduce the cost of some of these expenses, while others are non-negotiable.

As one can see from the above listing, there are many different categories of expenses that the retailer must monitor. There are several methods for classifying these expenses based on function and purpose of analysis. Traditionally, expenses were categorized as direct and indirect. With more complicated organizational structures of modern day stores and store groups, the methods of classification vary with the retailer. Regardless the classification model, there are direct and controllable expenses; fixed and indirect expenses; and variable expenses. These types of operating expenses will be discussed in more detail in *Part 3: 3-6 Contribution Margin* of this section.

For the skeletal P & L Statement, total operating expenses will be used. Total expenses, as the term indicates, are inclusive of all of the above types of expenses that a retail store incurs while doing business. Operating expenses are a one line entry on the skeletal P & L Statement.

And, as explained earlier, in the skeletal P & L Statement there is a relationship between the last three components: gross margin, operating expenses, and (net) operating profit, that is similar to the relationship between the first three components of the statement. Even though operating expenses and (net) operating profit are not included in the retail price formula, the same model for calculating a missing component when two other components are known is applicable.

By manipulating the gross margin formula, the operating expenses formula can be constructed. The following formulas may be used to solve for operating expense dollars and percent.

$$\text{Operating Expenses \$} = \text{Gross Margin \$} - (\text{Net) Operating Profit \$}$$

$$\text{Operating Expenses \%} = \text{Gross Margin \%} - (\text{Net) Operating Profit \%}$$

$$\text{Operating Expenses \%} = \text{Operating Expense \$} \div \text{Net Sales \$}$$

Problem: Calculate operating expense dollars and percent with figures provided below:

Example Figures for calculating the skeletal P & L Statement

Gross Sales = \$210,000.00	Customer Returns & Allowances = \$10,000.00
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Net Sales = \$200,000.00	Cost of Goods Sold = \$116,000.00
Gross Margin = \$84,000.00	Operating Expenses = \$72,000.00
(Net) Operating Profit = \$12,000.00	

Operating Expenses \$ = ?
Gross Margin \$ = \$84,000.00
(Net) Operating Profit \$ = \$12,000.00

Profit and Loss Statement Form

Component	Dollars (\$)	Percent (%)
Net Sales	\$200,000.00	100.00%
- Cost of Goods Sold	\$116,000.00	58.00%
= Gross Margin	\$84,000.00	42.00%
- Operating Expenses		
= (Net) Operating Profit		

1. Calculate operating expense dollars.

Operating Expenses \$ = ?
Operating Expenses \$ = Gross Margin \$ - (Net) Operating Profit \$
Operating Expenses \$ = \$84,000.00 - \$12,000.00
Operating Expenses \$ = \$72,000.00

2. Calculate operating expenses percent.

Operating Expenses % = ?
Operating Expenses % = Operating Expenses \$ ÷ Net Sales \$
Operating Expenses % = \$72,000.00 ÷ \$200,000.00
Operating Expenses % = 36.00 %

OR

Operating Expenses % = Gross Margin % - (Net) Operating Profit %
Operating Expenses % = 42.00 % - 6.00 %
Operating Expenses % = 36.00 %

Profit and Loss Statement Form

Component	Dollars (\$)	Percent (%)
Net Sales	\$200,000.00	100.00%
- Cost of Goods Sold	\$116,000.00	58.00%
= Gross Margin	\$84,000.00	42.00%
- Operating Expenses	\$72,000.00	36.00%
= (Net) Operating Profit		

It is imperative that retailers carefully and consistently monitor and control operating expenses. As previously discussed, expenses must be less than gross margin in order for the retailer to realize a profit. Expenses can change due to many factors -- even a change in weather. Therefore, the retailer must negotiate costs on as many expenses as possible. Some expenses are fixed and do not change with a decrease in sales volume or with an increase in cost of goods sold. In this scenario, the retailer must cut expenses; and, sometimes it might be at the cost of operating a profitable business. For example, the retailer, in an attempt to cut expenses, might decide not to run a promotional advertisement needed to create extra foot traffic that could possibly increase sales volume in the store. The last component of the skeletal P & L Statement or (net) operating profit will be discussed in the next segment of *Part 2*.