

**HOW TO GET TO THE  
NUMBERS THAT MATTER IN  
RETAIL**

*Martec International, Inc.*



# HOW TO GET TO THE NUMBERS THAT MATTER IN RETAIL

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MARTEC INTERNATIONAL ASSISTS RETAILERS TO IMPROVE PERFORMANCE IN THE BUSINESS PROCESSES OF BUYING, MERCHANDISE MANAGEMENT, MARKETING, SUPPLY CHAIN, WAREHOUSING, DISTRIBUTION AND STORE OPERATIONS. ADDITIONALLY, WE HELP VENDORS EXECUTE THEIR GO TO MARKET STRATEGIES WITH RETAILERS MORE SUCCESSFULLY.

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## INTRODUCTION

The objective of this white paper is to review various aspects of retail financial management and to draw important lessons for small and mid-size retailers. The paper addresses a wide range of topics that impact a retailer’s financial success. Many of these are common to retailers of all sizes, but some are specific to mid to small tier businesses and many cautionary notes are given. The topics covered include:

- Key financial metrics and their importance.
- Budgeting and financial planning.
- Relationship of financial plans to merchandise and Open-To-Buy plans.
- Purchasing management.
- Invoice matching.
- Vendor management and its relationship to cash flow.
- Co-op funds and vendor advertising support.
- Operational monitoring.
- Monday morning and end of month routines.
- Financial danger signs and how to avoid pitfalls.
- Managing the store at the Trading Statement level.
- Adding new stores and the implications for profitability and cash flow.
- Dealing with reverse premiums.
- Balance sheet management.
- Inventory—an asset or a liability?
- The role of computer systems in modern financial management.
- Compliance and the implications of Sarbanes-Oxley.

## KEY FINANCIAL METRICS

The table that follows shows the key metrics used by most retailers to track and manage their performance. In particular, The Finance Function is very concerned with Return on Capital Employed or Return on Net Assets, Inventory Turn, Gross Margin Percent, Expenses Percent To Sales and expenses measured by line item and expressed as a percent to sales. They may also be concerned with other measures such as the Quick Ratio, Acid Ratio, Gearing and Interest Cover. This latter set tends to be examined infrequently, perhaps quarterly, half yearly or annually.

Widely Used Through The Business	Buying & Merchandising	Store Operations	Finance	Marketing
<b>Sales</b> • Sales vs. Last year • Sales vs. Plan/Budget • Like for like Sales • Sales per Square Foot/Meter  <b>Inventory</b> • Stock Turn • Availability/In-Stock %  <b>Margins</b> • Gross Margins % • Markdown %  <b>Profit</b> • Pre-Tax Profit %	<b>Sales</b> • Sell Through  <b>Inventory</b> • GMROI • Fresh Stock % • Average Stock • Weeks of Supply  <b>Margins</b> • Markup % • GMROF	<b>Sales</b> • Average Sale (Money) • Average Sale (Items) • Conversion Rate • Transaction Count  <b>Inventory</b> • Shrinkage  <b>Margins</b> • Local Markdown %  <b>Labor</b> • Labor % Sales • Sales per FTE • Sales per Labor Hour • GMROL	• Return on capital Employed • Return on Net Asset • Interest Cover % • Expense Lines %	• Market Share • Share of the Purse/Wallet
			<b>Corporate &amp; Shareholders</b>  Corporate & Shareholders • Share Price • Earnings per Share	<b>Human Resources</b>  Employee/Associate Turnover • Training Cost per Associate • Absentee

## Return on Capital Employed

Return on Capital Employed (ROCE) is defined as:

$$\text{ROCE} = \frac{\text{Pre-tax Profit}}{\text{Capital Invested}} \times 100$$

Retailers make widely varying returns but as a sweeping generalization, a business should be making at least 16% to be considered a successful business. A good analogy is to consider that you could invest \$100 in a retail business or you could put it in a savings institution. In a savings institution you might currently earn 3% to 8% depending on investment, country and the prevailing level of inflation. To invest that money in a retail business carries a higher level of risk and should therefore, earn a higher level of reward.

The capital is invested in fixed assets and working capital. Fixed assets include buildings, fixtures and fittings, trucks, refrigeration units, etc. In retail, the biggest part of working capital is usually inventory. Accounts payable is another component, as is accounts receivable, which for most retailers is the balances outstanding on credit and debit cards that haven't been settled yet.

A variant on this measure is Return on Net Assets. This measures the pre-tax profit divided by the net asset value expressed as a percentage. For the purposes of this paper, they lead you to the same conclusions.

To improve the performance of your business, you can improve pre-tax profit, or reduce the capital employed to achieve the same profit, or do a mixture of the two.

Improving pre-tax profit requires some mix of:

- Growing sales.
- Increasing gross margin percent.
- Reducing expenses as a percent to sales.

Reducing the level of capital employed to make a given profit involves:

- Squeezing more productivity out of fixed assets such as selling space and fixtures.
- Reducing the inventory investment necessary.
- Collecting settlement faster from the credit card companies and banks.

## Inventory Turn

Inventory (Stock) Turn is the most usual measure of the efficiency of inventory control. It is the number of times within a period, usually one year, that the average inventory is sold.

Normally, higher stock turn rates are associated with products that sell at a lower gross margin percentage, for example, groceries. Conversely, a higher turn has to be associated with a low margin; otherwise, the retailer will not stay in business. Department stores are an example of this lower turn, higher margin model.

Inventory turn is calculated based on the retailers accounting method. Many retailers use the Retail Method of Accounting, otherwise known as the Retail Inventory Method. In this approach, inventory value is maintained and reported at retail or selling price and converted back to cost when the balance sheet is prepared.

Turn can be calculated as follows:

### Cost Method

$$\text{Inventory turn} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory At Cost}}$$

### Retail Method

$$\text{Inventory turn} = \frac{\text{Sales}}{\text{Average Inventory At Retail}}$$

At its simplest, improving inventory turn involves increasing sales, reducing inventory, or a combination of both. However, few things are as simple as first seen. A retailer can boost sales, but will need to reduce, or control the amount of inventory needed to drive the sales. If the sales increase is matched by a like growth in inventory, the desired result will not be achieved.

	Office Max	Office Depot
Turn in 1995	3.0	3.1
Turn in 2000	3.4	7.2
Sales 2000	\$ 4,636m	\$ 11,154
Inventory at Cost	\$ 671m	\$ 922m
Inventory at Retail	\$ 884m	\$ 922m

In the chart above two leading office supply companies are compared. The performance of Office Depot clearly shows that increasing turn can be done without hurting revenue growth. Five years later, Office Depot did 2.4 times the sales on 1.4 times the inventory.

Other factors need to be considered when planning a desired turn level. Average turns vary by retail sector, and should be used as a barometer when plans are made. It is possible to turn too fast. Excessive turn can result in lower customer service levels due to higher out of stocks for the consumer. Studies have shown that consumers confronted with continuous out of stocks will soon shop elsewhere.

Turning too slow can also damage a retailer by requiring extensive amounts of capital to finance bloated inventories. Slower turning products frequently require markdown funds to clear older, unwanted inventory. Excessive inventory investment has contributed to many retailers demise.

The following table based on a review of leading US retailers, shows the average turns by retail segment.

RETAIL SEGMENT	INVENTORY TURN
Automotive Supply	2.50
Book Stores	2.15
Consumer Stores	16.00
Department Stores	3.50
Drug Stores	5.40
Fashion Specialty	6.50
Home Decor	3.35
Home Improvement	4.00
Jewelry	1.30
Mass Merchandisers	4.50
Music / Entertainment	2.65
Off Price	4.30
Office Supplies	5.50
Pet Supply	6.67
Shoes	4.20
Sporting Goods / Leisure	2.60
Supermarket	10.00
Toys	2.00
Warehouse Club	8.50

### Gross Margin Percent

Gross Margin (GM) is the lifeblood of a retailer. Simply defined, it is the difference between the net sales and the merchandise cost. Gross Margin Percent (GM%) is the further relationship of Gross Margin to Net Sales. The calculation is relatively straightforward:

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

While Gross Margin is important, a better indicator of performance is Gross Margin %. As sales are actualized, they may show significant variance from the plan. How many GM \$ you realize will inevitably also vary from your plans. But, by using GM% you have a more accurate indicator of your performance on a week-to-week, monthly or seasonal basis.

Planning your GM% is a vital part of understanding how to run a successful retail operation. With planned margins too high, customers may see you as overpriced and will look elsewhere to shop. Too low, and you may have trouble with cash flow and staying alive.

Retailers can impact GM% by either lowering costs or raising prices. Raising prices is easier, but can be deadly to the consumer. Lowering the cost of goods is not an easy task, but may provide the retailer with a significant competitive advantage.

### Expenses Percent To Sales

There are three major components to a retail Profit and Loss (P&L) statement. These are sales, cost of goods and expenses. Hence there are three major ways to improve profitability—grow sales, reduce cost of goods or reduce expenses. Reducing or containing expenses is vital. The calculation is:

$$\text{Expenses \%} = \frac{\text{Total Non-Merchandise Expenses}}{\text{Net Sales}} \times 100$$

Expenses generally run out between 20% and 45% of sales, depending on retail format. (Warehouse clubs are much lower). There are three important measures to track:

- Expense percent to sales verses plan or budget (see below).
- Expense percent to sales verses last year.
- Expense percent to sales verses competitors.

The first two bullets should be measured and monitored weekly. In the case of the first one, comparisons should be made between this week this year and the same week last year, and then year to date this year verses year to date last year. For the second bullet, the comparison should be this week verses plan for this week and this year verses plan for this year.

The third bullet can only be reviewed half yearly or annually. Annual reports (or half yearly statements) should be obtained for public companies in the same retail segment and their expense percent to sales calculated. This can then be compared with your company's figure to yield valuable information.

When making the comparison, it is important to remember that higher service operations have a higher expense percent as service costs more, so the right companies should be selected for comparison.

Generally speaking small and medium retailers mostly need to focus on assortment and service, since they don't have the economies of scale to lead on price. This may result in a higher expense percent (but it may not—see below).

Having looked at total expenses, it is important to repeat the exercise for each line item in the P&L. For example, store labor is the biggest expense item for all retailers and ranges between 8% and 16% of sales. Four main categories of expenses—staff, space (or occupancy), marketing and distribution account for the lion's share of all expenses.

The items listed below should be calculated as a percent to sales with comparisons done as follows:

- This week verses this week last year.
- Year to date verses year to date last year.
- This week verses plan this week.
- This year verses plan this year.

In the US, it will generally not be possible to compare this level of detail with other retailers, as public companies do not publish their results at this level of detail. In some other countries, such as the UK, it is

possible to compare staff percent to sales.

Smaller retailers can sometimes economically sustain a higher staff cost percent to sales (and give better service than big chains) because they don't carry the headquarters overhead that big chains carry.

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## BUDGETING AND FINANCIAL PLANNING

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As the previous section indicates, it is important to have a well thought out budget or plan for the current fiscal year.

Most larger retailers have a series of financial plans. These include a five-year outlook, a three-year forecast, and annual and seasonal plans. Naturally, the forecast accuracy increases as the time horizon gets closer in.

Why have a five and three year plan? These are used to set expectations on market expansion, profit margins, capital expenses and cash requirements. Retailers looking to grow their company make extensive use of this long range forecasting. The five-year outlook may only look at a few KPIs such as Sales, Margin, Inventory and Expense expectations. A three-year view will include additional KPIs and often add more detail lines to each.

Annual and seasonal plans involve more levels of detail and decreased margins of error. A main function of annual planning is to establish budgets for payroll, inventory, shortage, operations expenses and other headings. Additionally, these financial plans are used as the basis for creation of lower level store and merchandise plans.

As strategic planning becomes more ingrained into the core processes of retailers, many retailers are realizing other issues arise. Issues relating to plan ownership, version control and data inputs become vital to producing optimal plans. Modern software solutions can integrate strategic plans with merchandise plans as well as utilize the same sales and financial data as other core merchandising systems.

When developing financial budgets, it is extremely valuable to be able to examine the last two or three years financial performance at the detailed level and identify trends in, for example, gross margin %, staff costs percent to sales, occupancy costs percent to

sales, etc. Once a plan is built, the resulting percent to sales figures should be compared to prior year results to check for sensibility. Good accounting software solutions can generally provide this capability.

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## RELATIONSHIP WITH MERCHANDISE AND OPEN-TO-BUY-PLANS

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Financial budgeting results in setting a sales target for the company. Retailers then build merchandise plans that start to break out how those sales will be achieved. Often, the sales goal built into the merchandise plan will be higher than the sales budget. This gives some room to under achieve the merchandise plan (usually the highest risk area for retail profitability) and still make the financial plan. (Note: Expenses are geared to the financial plan not the merchandise plan).

Smarter financial management involves coordinating merchandise plans with financial plans and the rolling Open-To-Buy (OTB) process. The problem for most companies is trying to keep the merchandise plan constant and unchanging, while the OTB is a dynamic, fluid tool.

Open-To-Buy is a mechanism designed to direct and control spending by the buying and merchandising operation. It ensures that enough merchandise is bought to support the merchandise plan and that overspending is reduced. The OTB is a tactical tool updated weekly, or monthly depending on the retailer. In most cases, OTB plans are produced at department or class level, though they can be produced at all levels of the merchandise hierarchy.

Fashion and other retailers of seasonal merchandise, such as toy retailers, use Open-To-Buy extensively. Grocers and other retailers with very stable inventories that don't peak very much tend not to use Open-To-Buy techniques.

Open-To-Buy exists in two forms:

- The Open-To-Buy plan produced in advance of the season or year, as part of the merchandise planning process.
- An in-season or in-year control mechanism updated on a monthly or weekly basis. (Fashion retailers tend to monitor OTB weekly, retailers selling less risky merchandise tend to do this monthly).

Retailers using the retail method of accounting will do most of the calculations at selling price. Retailers using cost accounting can convert sales at retail to sales at cost and then follow the same basic model.

The problem with reconciling the merchandise plan with the Open-To-Buy is the expectation that the plans should not change, but the OTB must reforecast its future numbers to ensure smooth operation. The relationship that links the two is not the actual dollar plans, but the percents contained in the merchandise plans. If a retailer is not meeting sales plans, they should look to reduce future purchases (where sensible) to maintain the inventory to sale ratio previously planned.

One of the keys to successfully implementing an Open-To-Buy process is integration to other core merchandising processes and systems. Processes and systems such as purchase order management, merchandise and financial planning, warehouse management and inventory management should all be linked to the OTB process. This integration will eliminate many trouble spots and is offered by many software solution providers.

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## PURCHASING MANAGEMENT

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Purchasing management is a key component of smarter financial management for any retailer, regardless of size. One of the most effective means of controlling purchases is to implement and enforce the use of an Open-To-Buy process.

As stated above, OTB is a tool designed to direct and control spending by the buying and merchandising divisions. A simplified OTB for 6 periods (6 months or 6 x 4-week periods) is represented on the next page:

Open-To-Buy = Closing stock – opening stock – on order + sales.

When the Open-To-Buy figure is negative, as in periods 1 and 3 above, retailers are said to be overbought and have too much stock.

A true Open-To-Buy will account for many other factors such as markdowns and other financial adjustments that might impact margins or inventory levels. Some retailers also show unapproved On Order as a barometer for what else might happen.



	P1	P2	P3	P4	P5	P6
Opening Inventory	865	1205	1476	1812	1982	1512
On order	950	600	1230	57	20	17
Estimated Sales	486	501	704	792	1020	962
Closing Inventory	1205	1476	1812	1982	1512	1015
Open to Buy	(124)	172	(190)	392	350	295

As each month passes the planned numbers from the merchandise plans are updated with either revised forecasts or actual numbers. As a forecasting tool the OTB can be revised weekly to reflect updated plans based on trend and any anticipated changes in future months.

A key aspect of using an OTB is the agreement of the revised forecast between the merchant and their senior merchant (or owner perhaps in a small company). Once they agree what the future might look like, they can then discuss an action plan to impact on-orders, markdowns or even the promotional calendar to reflect their new view of what is to come. By design, the OTB is not a sophisticated forecasting tool, but should rely on outside applications and information to help the merchant revise forecasts.

The senior merchant’s role is one of summary, control and oversight. The senior merchant should also have an OTB reflecting their area of responsibility. An aggregation of the lower level OTB should be compared and managed to an OTB they maintain. They must monitor merchant compliance to agreed actions, approve or deny additional purchase orders, and hold monthly meetings to review.

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## VENDOR MANAGEMENT AND ITS RELATIONSHIP TO CASH FLOW

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Part of smarter financial management for many retailers is negotiating favorable payment terms. These terms can dramatically impact the cash flow for any size retailer.

There are two main issues when negotiating payment terms with vendors. One issue is when payment falls

due, the second is to negotiate a tiered approach to payment. For example if you secure payment terms of Net/30 – you would be expected to pay the balance in full 30 days from receipt of goods, with no interest penalties. However, many retailers can include other tiers of payment, with rebates for early payment, perhaps a 3% rebate if paid on delivery, or 1% if paid in 15 days, etc. Late payment terms can also be discussed – say, a 1% penalty for paying at 45 days, maybe 3% for payment at 75 days, and so on.

Why are terms so important? Take diapers, for example. Say a retailer sells on average 1000 units per month. Negotiated payment terms are Net/30. If the retailer purchases 1000 units a month, and pays in 30 days, there is no financial carrying cost. Payment is made about the same time all the units are sold. If the retailer negotiates payment terms of Net/45, then they would have use of the cash for 15 days until required to send payment. The cash can be put on deposit and earn interest. While the interest earned may be a tiny percentage, it is free money. There is a school of thought in the US that many grocery retailers’ entire profit derives from the interest they earn on the cash float. (US grocery retailers average about 1.4% pre-tax profit).

When running the accounts payable and determining what invoices to pay, it is important to review the cash on hand first and assess impending cash needs. If there is sufficient cash on hand all currently due invoices can be paid. If this leaves some cash that is surplus to immediate requirements, it is often wise to review paying some other invoices early. If the settlement terms are such that the interest you lose on the cash float is more than offset by the settlement discount you can take for early payment, then these invoices should be paid early. If there is insufficient cash on hand to meet all currently due invoices, then those invoices delayed for payment should be the ones

with the least penalties negotiated when the terms were established. This flexibility can be so important that some organizations base part of their buyers' bonus on improvements they can negotiate to terms.

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## CO-OP FUNDS AND VENDOR ADVERTISING SUPPORT

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Many larger retailers negotiate co-op funding from the vendors. This funding traditionally covers advertising costs to market specific merchandise. These funds are restricted by the vendor and will only be paid if certain pricing and presentation rules have been met.

Other vendor funding is negotiated in other segments. It's quite common in grocery to negotiate and receive "slotting fees" from the vendors to obtain the best "slots" on the shelving units. Fees are higher for eye level shelves near the ends of the aisles than would be charged for a bottom shelf, middle of the aisle slot. As grocery purchases are heavily based on impulse, vendors will pay these fees to have their product seen first.

In the department store segment, buyers often negotiate guaranteed margins for certain products. The vendor commits to a minimum gross margin percent for their merchandise. If the department store is forced to sell these products at a greater discount than anticipated, the vendor will contribute enough funds to bring the gross margin of that product back to the negotiated level. In this type of arrangement, the retailer and vendor often discuss retail pricing and promotional schedules in advance.

Other co-op funding for larger retailers can be found in trailing rebates of 1-3% for purchasing various volume levels of goods. In some cases vendors will purchase custom fixtures and visual displays for the retailers stores.

The problem for the mid-size retailer is a lack of leverage with the vendor, as they do not have the buying power of the multi-billion dollar retailers. Often co-op funding is limited to a single ad in a year or maybe a season. In some cases though, smaller retailers may be able to negotiate volume rebates.

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## MONDAY MORNING AND THE END OF MONTH ROUTINES

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Weekly and monthly performance reviews are essential to smart retailing. A standard set of reports should be designed to best meet the needs of the intended audience. While this is considered standard practice for most retailers, it is only the beginning.

Leading companies have redesigned these reports from information to be reviewed, into actionable reports. The difference? Actionable reports eliminate content that requires little or no action on the part of the reviewer. For instance, weekly Best Seller reports are common for most larger retailers. But, what can a merchant do with this information? The entire report must be studied to identify potential lost sales, overstocks, excessive markdowns, etc. An actionable report alternative could show the top 10 selling items with low on-hands and no on-order. Another could be slow selling styles with excessive on-hands and additional merchandise on-order.

While virtually all merchandising and financial solutions provide reporting, competitive advantage comes from having actionable reports. Newer solutions offer the ability to create or customize your own reports. Simply having needed information presented in an effective way can provide surprising productivity and improved results.

For a senior merchant an actionable report could show weekly performance by department vs. plan—but only show those areas under-performing by a defined percentage. Another example would be to track vendor sales across departments and show only those vendors whose maintained margin is falling below agreed levels.

These actionable reports enable quick response and provide immediate focus on the key business issues. Speed of response is vital to the mid-size retailer; they can often react faster than the larger chains. It's a competitive advantage that many retailers currently exploit.

## INVOICE MATCHING

Retailers raise Purchase Orders (POs) and send them to vendors. Goods shipped to the retailer by the vendor are accompanied by a shipping manifest. Upon arrival, the retailer normally checks off receipts against the shipping manifest to identify discrepancies. At some later point, the retailer invoices the goods.

To pay the invoice, retailers retrieve the PO and the shipping manifest, match them to the invoice and approve the invoice for payment if all three documents agree. Historically, about 30% of these document sets will have discrepancies. (Improvements in supply chain processes and increased collaboration with suppliers can reduce these problems.)

When the documents fail to match, some retailers set a percent variance tolerance rule, and will pay invoices whose discrepancies fall within the allowed variance. The thought being that the effort to resolve small discrepancies is not worth the additional cost to the retailer to research and resolve. For problem invoices falling outside of this tolerance, the retailer may either hold the entire payment or send partial payment until the issue has been researched and resolved.

The efficiency of this process can be improved by using an automated invoice matching program, scanning paper documents into a document management system, and doing all filing and retrieval electronically.

Retailers with an EDLP (every day low price) philosophy normally see a lower incidence of matching discrepancies. This is because they don't suffer from promotional prices being incorrectly applied as a major source of problems.

## FINANCIAL DANGER SIGNS AND HOW TO AVOID PITFALLS

As discussed above, weekly and monthly analysis is important to review actual performance vs. planned expectations. The objective being to recognize potential problems and issues before they become threats to the company. There is a variety of danger signs to watch for when reviewing performance, these include:

- Unplanned and continual decreases in comp store performance.
- Decreasing margins (gross and net) vs. plan while maintaining sales rates.
- Excessive markdown rates further eroding margins.
- Sustained overages in expense percents compared to plans. This could include:
  - Increases in labor costs—wages, benefits, unemployment insurance, etc.
  - Overspends in store maintenance budgets.
  - Sustained losses in cash investments, etc.
- Poor inventory sell-through rates vs. plan.
- Weaker sales vs. plan in stores facing a specific competitor.
- A build up of aged inventory (Refer to the "Inventory—An Asset or a Liability?" section below)

The advantage of weekly reports is speed. These reports should incorporate more than Week, Month and Season summaries. They need to include This Year actuals, Last Year and Planned data. Many fashion retailers also include at a rolling three-month view to help them identify current trends.

The past is littered with failed retailers, most of whom could say with hindsight, where they started to go wrong. The advantage of actionable weekly and monthly reviews is clear insight—insight into trends both positive and negative. Running a business on traditional reporting methods costs the retailer time and clarity. Ignoring warning signs of poor or undesired performance will lead to a risky future.

Some general guidelines are:

- If desired sell throughs are not being achieved, take the markdown early. A 20% markdown early in the season may do a lot more to clear the goods than a 50% markdown in the end of season sale.

- Consider developing an automated markdown recommendation model, that identifies under achieving products and generates markdown recommendations.
- When comparable store sales are declining, check that you have enough inventory on hand in the right categories. Then drill down to identify categories that are still growing and exploit those more.

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## MANAGING THE STORE AT THE TRADING STATEMENT LEVEL

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Store management also requires effective reporting. Stores today are confronted with shrinking budgets and demands for higher productivity. Managers have little time to spare for reviewing reports and completing paperwork. As actionable reports have been introduced to the merchants and corporate staff, store line reporting must also evolve in the same way.

Each store should be looked at as a complete business, each with its own Profit and Loss (Trading) statement. However, not all items on a store P&L can be impacted by store management (for example depreciation). Hence, their reports should focus on variables they can manage, such as labor, maintenance and of course sales. As in corporate reporting—these reports need to include this week, this week last year and plan, to have a true comparison. Many retailers will show how one store compares to the average store as yet another comparative.

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## ADDING NEW STORES AND THE IMPLICATIONS FOR PROFITABILITY AND CASH FLOW

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Adding new stores is an important way of growing a retail business. However, it is important to realize that new stores take three to five years to reach maturity and in their first year or two, they may be unprofitable. Hence the rate at which new stores are opened requires very careful planning.

In addition, if stores are opened at too fast a rate, it detracts management attention from existing stores and their performance may suffer. Hence, it is very important to track comp store sales on a weekly basis and react to any adverse trends.

Comp store sales is defined as the sales increase this year over last, only for stores open in both years. Hence, it removes the impact of new store openings. There have been many examples of companies reporting sales growth while comp store sales were declining. The added sales from the new stores camouflaged problems in the existing store base. In the longer term, the new stores report declining comp store sales adding to the general decline.

Comp store sales can be measured for this week, this month, season to date and year to date. When reviewing comp store sales, it is important to know the current inflation rate. For example, suppose inflation is 2% and comp store sales are 5%. What this really means is that the business is doing 3% better than inflation, so unit volume is growing. If inflation is 4% and comp store sales is 2%, unit volume is really shrinking at 2% a year.

It is also helpful to know what competitors or similar retailers are doing. The financial press reports comp store sales figures for public companies on a monthly basis, so it is easy to keep track of other similar retailers in this regard.

While all companies need to address declining comp store sales, it is doubly important for companies opening a significant number of new stores relative to their size.

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## DEALING WITH REVERSE PREMIUMS

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Depending on the real estate market for retail locations, retailers can occasionally attract reverse premiums for vacant retail stores. In other words, when a retailer is considering a move, real estate companies might pay them a sum of money to encourage the retailer to leave their current site and move into another that is listed by an agent. Any premium given is normally dependant on the length and size of the new lease.

Many retailers have been encouraged to lease secondary or unattractive locations in order to get reverse premiums. In some cases, these retailers have

subsequently filed bankruptcy based on an unfortunate site selection. The danger is that the premium disguises the true profitability of the store and later comes home to roost in the store's second year of trading.

A retailer paying a premium price to get a prime location is one thing, receiving reverse premiums from a realtor or mall developer is something to treat with a great deal of caution.

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## BALANCE SHEET MANAGEMENT

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Maintaining a healthy balance sheet is critical to any business. In retailing, a significant portion of the finances raised to fund the business may be secured against the assets in the company's balance sheet.

There have been well known instances of large retailers with severe inventory problems who were forced to overstate the true inventory value on the balance sheet. Marking down the inventory to its true market value would place some of these retailers in breach of their banking covenants causing them to be technically insolvent. Hence, they were not able to take badly needed markdowns to clear the inventory and purchase new goods.

Smarter retailers regularly review inventory aging reports. Special attention is paid to seasonal merchandise and other goods with a pre-determined shelf life. Taking markdowns in a timely fashion may create pressure on the Open-To-Buy in the short term, but will greatly enhance the long-term viability of the business.

Retail is intrinsically a cash business. Managing the relationship between inventory turns and vendor payment times is another critical aspect of keeping a healthy balance sheet. Utilizing effective financial and merchandising software solutions can greatly improve insight and understanding of the financial health of a retail operation.

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## INVENTORY—AN ASSET OR A LIABILITY

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As discussed above, inventory can be seen as an asset or a liability. Bankers and accountants typically view it as an asset. A merchant, however, may see the same stock as a liability.

Age is the key. As mentioned above, leading retailers have a monthly review process to understand the age of their inventory. Age is typically defined as the length of time in weeks since the retailer last received the merchandise. This definition may vary somewhat by retailer, but the concept remains constant, age is important.

What defines "old" merchandise? This varies widely by retail segment. In ladies fashion areas such as Dresses or Juniors, anything older than six to eight weeks is deemed "transitory". For these merchants, goods in stock for over 10-12 weeks are considered "old" and are a significant liability. This type of fast paced fashion goods has a short life span for a retailer and has a smaller tolerance for age.

Merchants who sell commodity goods such as bed pillows have a completely different range to describe old age. Styles rarely change and may be continued by a vendor for years. Innovation may add new styles, but rarely displace existing goods. For a merchant in this type of business, the aging issue is not a concern. Goods can be in stock for months with little concern about becoming unsellable to a consumer. The concern for this merchant is not one of the age of the merchandise, but the amount of money tied up in slow selling goods. Consumers express little reluctance to buy the same pillow style year after year. Their only concern being that the pillow is clean and in good physical shape.

Other areas such as appliances, commodity clothing, household products and other similar businesses see age as a problem at months, not weeks, and tend to take permanent price reductions less frequently on the products.

Understanding these concerns, successful retailers view inventory as an asset or liability as a combination of age and productivity depending on the type of merchandise considered. Different rules should be defined for the needs of each category. Usage of current inventory management systems will enable a retailer to better understand the status of their inventory. Retailers can then anticipate problems and minimize any potential liabilities.

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## COMPLIANCE AND THE IMPLICATIONS OF SARBANES-OXLEY

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The introduction of the Sarbanes-Oxley legislation in the US has placed significant demands on Chief Financial Officers. CFO's must now ensure that their reported financial statements are a true reflection of the state of the business. While this has always been the assumed case, and auditors might sign the accounts, declaring that they are a true and fair view, in many highly publicized cases it has later been proven otherwise. This new legislation requires the CEO and CFO to both sign the accounts and risk jail sentences for false declarations. With this in mind, achieving true reporting compliance has become much more important to the CFO.

One way that many companies are addressing this issue is to upgrade their financial systems, desiring comprehensive, fully integrated and readily auditable systems as their new solution to ensure better reporting. Additionally some larger companies are appointing compliance officers. Smaller businesses with less complexity do not need to go as far as appointing compliance officers. For them, having an effective, up to date financial software solution and a robust auditing process will address the majority of the problem posed by the new legislation.

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## THE ROLE OF SOFTWARE SOLUTIONS IN MODERN FINANCIAL MANAGEMENT

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New legislation, expanding national competition, and an increasingly demanding consumer have all applied pressure to the mid-size retailer. Information technology can be a significant aid to smarter financial management for any retailer. Solutions that impact this issue are not just the obvious financial systems.

Newer generations of software solutions have dramatically improved over what was available only a few years ago. If a retailer has a specific issue, many will seek a best-of-breed type solution. With these point solutions, retailers will need to understand the issues involved with integration with legacy systems, maintenance, staffing knowledge requirements and data compatibility. Many retailers are finding that a fully integrated Enterprise Resource Planning (ERP) software solution is a viable alternative, solving many

issues with one solution. Understanding which path is the correct one varies by circumstance and need.

Effective use or upgrades to a wide variety of software solutions can dramatically impact successful financial management. For instance:

- Modern supply chain solutions can provide the entire retail operation with a clear view of the movement of their most significant investment—inventory. Improved visibility provides insight and focus on areas for improvement. Significant benefits can be found in the supply chain to impact the finances of any retailer.
- Inventory & purchasing management solutions enable tighter management of Open-To-Buy issues.
- Improved forecasting systems can enhance the accuracy of financial and merchandise plans. Better forecasting leads to clearer direction and control of the company's future.
- Even the humble spreadsheet can be an invaluable tool for all sorts of planning, forecasting and analysis. In fact, it could be argued that Microsoft Excel is the most widely installed merchandise management system in the world.
- Financial software solutions need to be current, highly auditable and most importantly, integrated to other core systems to ensure accuracy in reporting.

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## SUMMARY AND CONCLUSIONS

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This paper has reviewed a wide range of topics and processes relating to financial management and how smart financial management can improve business performance and profitability. Even small changes in key metrics can have a large impact on the bottom line. Retailers of all sizes can make dramatic improvement to their businesses by upgrading financial management processes and IT solutions.

Smarter retailers drive their business by utilizing processes and software solutions such as purchase management, strategic financial planning and

actionable reporting. Timely and actionable reports increases productivity, response time and help lessen some of the risks of running a retail business. Upgrading software and IT systems to integrate financial plans with purchase order management, Open-to-Buy and inventory management solutions can help drive down inventory costs, unify and create a common set of goals for the company, and improve profits.

The largest retailers use all of these developments today. However, very many of them can be used by small and medium sized businesses. In many cases, size is not a barrier to adoption. There are software solutions that can provide many of the capabilities of the larger companies and in many cases the 80/20 rule applies. For 20% of the effort and sophistication, you can get 80% of the benefits. While upgrades to financial systems may not seem as exciting, the returns can be significant.

Microsoft Dynamics is a line of integrated, adaptable business management solutions that enables you and your people to make business decisions with greater confidence. Microsoft Dynamics works like familiar Microsoft software such as Microsoft Office, which means less of a learning curve for your people, so they can get up and running quickly and focus on what's most important. And because it is from Microsoft, it easily works with the systems your company already has implemented. By automating and streamlining financial, customer relationship and supply chain processes, Microsoft Dynamics brings together people, processes and technologies, increasing the productivity and effectiveness of your business, and helping you drive business success.

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