

RETAIL MANAGEMENT – LECTURE 6

CHAPTER 6 – FINANCIAL STRATEGY

Overview

To begin, consider the different types of objectives that retailers have. The strategic profit model is then introduced, and it is used to analyze the factors affecting a firm's financial performance, as well as approaches for improving performance, in the following section. In this demonstration, you will see how you can use the model to evaluate one of the growth opportunities and how you can look at productivity measures that evaluate the performance of retailing activities such as merchandise management and store operations.

Desired Learning Outcomes

1. Discuss how is retail strategy reflected in a retailer's financial objectives.
2. Identify the two paths to improve financial performance of retailing base on operating expenses or increasing sales.
3. Analyze the different financial operating characteristics base from the different types of retailers.
4. Explain the strategic profit model as a vehicle for understanding the complex interrelations between financial ratios and retailing strategy in retailing management.
5. Demonstrate some financial performance measures to evaluate different aspects of a retailing organization.

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Learning Objective 1 – The Objectives and Goals

When the retailer realizes that its objectives are not being met, it knows that it must take corrective action. The following are three types of objectives that a retailer might pursue:

(1) financial - not necessarily profits, but return on investment (ROI) – primary focus

Profits are usually the first thing that comes to mind when evaluating a company's financial performance: what were the retailer's profits or profit as a percentage of sales last year, and what will they be this year and in the foreseeable future? However, return on assets, rather than profits, is the most appropriate financial performance measure. The profit generated by the assets owned by the company is referred to as the return on assets (ROA).

(2) societal - helping to improve the world around us

Societal objectives are linked to broader issues that benefit society as a whole, such as making the world a more pleasant place to live.

Examples include retailers who are concerned about providing employment opportunities for people in a specific geographic area, minorities, or people with disabilities, among other things. Aside from providing people with unique merchandise, such as environmentally friendly products, other societal objectives might include providing an innovative service to improve personal health, such as weight reduction programs, or sponsoring community events.

(3) personal - self-gratification, status, respect

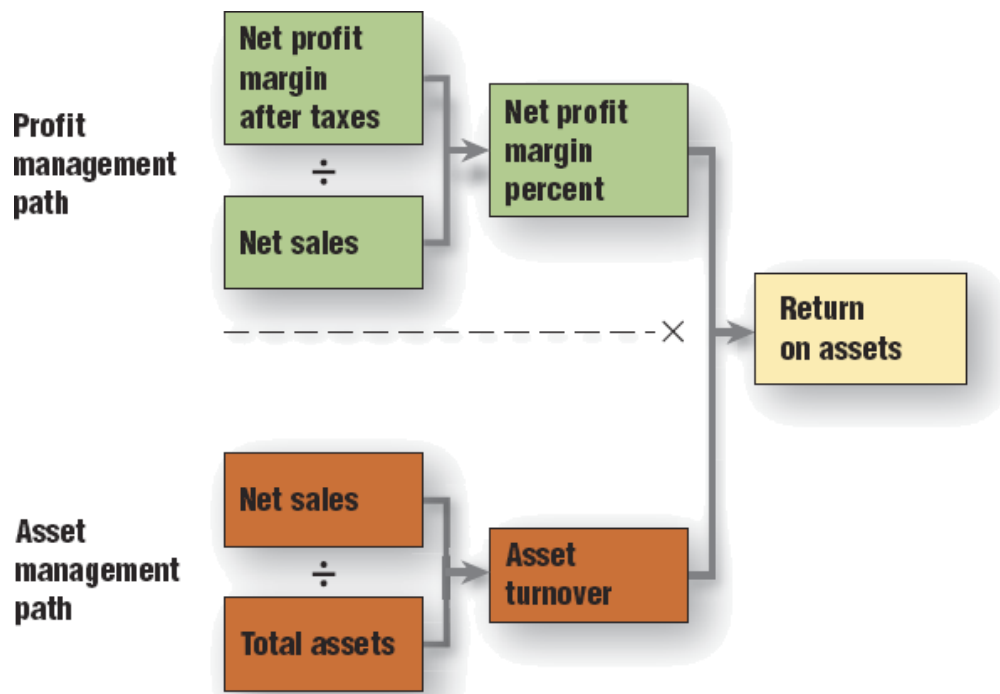
Many retailers, particularly those who own small, independent businesses, have important personal objectives, such as self-gratification, social status, and respect, that they want to achieve. In the case of a bookstore, for example, the owner/operator may find it rewarding to interact with other people who enjoy reading as well as with authors who come

to the store to promote their books. A retailer who operates a successful store may be recognized as a well-respected business leader in the community as a result of their efforts.

Learning Objective 2 – Strategic Profit Model

It is depicted in Exhibit 6–1 that the strategic profit model is a method for summarizing the factors that influence a firm's financial performance, which is measured by return on its assets. Return on assets (also known as return on assets) is an important performance measure for a company and its stockholders because it measures the profits that a company makes in relation to the assets that the company owns. When compared side by side, two retailers who each generate Php1 million in profits appear to have similar performance on the surface. However, if one retailer has Php 10 million in assets and the other has Php 25 million, the performance of the two retailers appears to be quite different. As a result, the first would outperform the second because it requires fewer assets to generate profit than the latter. As a result, a retailer cannot be solely concerned with maximizing profits. It must make a profit in the most efficient manner possible by maintaining a balance between profit and the assets required to make the profit.

EXHIBIT 6–1 Components in the Strategic Profit Model



The operating profit margin, also known as earnings before interest and taxes (EBIT), of a retailer is a measure of the profitability of the retailer's continuing operations. It is also a useful predictor of the retailer's future profitability. Total net sales divided by total assets equals asset turnover for a retailer. This financial measure assesses the productivity of a firm's investment in its assets and indicates how many dollars are generated for every dollar invested in assets—the amount of money generated by the firm's sales in relation to the amount of money invested in the assets required to generate the sales. As a result, if the asset turnover of a retailer is 3.0, the retailer generates Php 3 in sales for every peso invested in the firm's assets.

The retailer's ROA is determined by multiplying the two components together:

$$\text{Profit Margin} \times \text{Asset turnover} = \text{Return on assets (ROA)}$$

$$\frac{\text{Net profit}}{\text{Net sales (crossed out)}} \times \frac{\text{Net sales (crossed out)}}{\text{Total assets}} = \frac{\text{Net profit}}{\text{Total assets}}$$

The strategic profit model decomposes ROA into two components:

- (1) operating profit margin percentage and
- (2) asset turnover.

They demonstrate that return on assets (ROA) is determined by two sets of activities: profit margin management and asset turnover management, and that a high ROA can be achieved by a variety of combinations of operating profit margins and asset turnover rates.

Profit Margin Management Path

It is the retailer's income statement, also referred to as the statement of operations, that contains the information that is used to examine the profit margin management path. The income statement summarizes a company's financial performance over a period of time, which is typically a quarter or a year, and is prepared by a financial analyst. A lot of retailers choose to start their fiscal year on February 1 and end it on January 31 of the following year in order to capture all of the sales, gift card purchases, and returns that occur during the holiday shopping season.

Components in the Profit Management Path

Net sales, cost of goods sold (COGS), gross margin, and operating profit margin are the four components that make up the profit margin management path. Total revenues received by a retailer from the sale of merchandise during a specific time period are referred to as net sales. Customer sales are deducted from the credit and cash refunds that customers received for returned merchandise to arrive at the source of revenue. Special charges to customers and credit card interest are examples of sources of revenue that are not included in net sales calculations. Payments from vendors, for example, are a source of additional revenue for some retailers in addition to their merchandise sales.

For example, Supermarket retailers frequently charge consumer packaged goods manufacturers a fee in order to stock a new product on the shelves of their stores. Vendors may also be required to pay a penalty if the merchandise purchased from them does not comply with all of the terms of the purchase agreement, such as those pertaining to delivery. In most cases, such payments from vendors are reflected on the income statement as a reduction in cost of goods sold (COGS).

Cost of goods sold (COGS) consists of the amount of money a retailer pays to vendors in exchange for selling their products. Gross margin, also known as gross profit, is the difference between net sales and the cost of goods sold. It is an important measure in retailing because it indicates how much profit the retailer is making on the merchandise sold, without taking into account the expenses associated with operating the store and corporate overhead expenses, which are excluded from the calculation.

Gross margin = Net sales – Cost of goods sold

Operating expenses include **selling, general, and administrative (SG&A) expenses** in addition to the depreciation of the retailer's assets. Sales and general and administrative expenses (SG&A) include overhead costs associated with normal business operations, such as salaries for sales associates and managers, marketing expenses, utilities, office supplies, transportation from the retailer's warehouse to its stores, and rent. In addition to depreciation and selling, general, and administrative expenses (SG&A), some retailers will include other expenses, such as the cost of opening or closing stores and/or the cost of integrating an acquisition into their operations, as operating expenses. For the purpose of estimating a retailer's operating expenses, it is necessary to determine whether these other expenses are directly related to the retailer's normal operations or whether they are extraordinary nonrecurring expenses that arise only during the fiscal year in which they are incurred. If a growing retailer opens new stores each year, expenses for store openings may be incurred year after year, whereas expenses associated with an acquisition are likely to

be incurred only in the year of the acquisition and may not be indicative of the operating income that the retailer will realize in the future.

Operating profit margin, also called *earnings before interest and taxes (EBIT)*, is the a measure of gross margin less operating and extraordinary recurring expenses To summarize, the net profit margin is equal to the operating profit minus interest and taxes. Operating profit margin is important because it reflects the performance of retailers' fundamental operations, rather than the financial decisions that retailers make regarding taxes and capital structure, which are also important (borrowing money versus selling stock).

$$\begin{aligned} \text{Operating profit margin} &= \text{Gross margin} - \text{Operating expenses} - \text{Extraordinary} \\ &\quad \text{(recurring) operating expenses} \\ \text{Net profit margin} &= \text{Operating profit margin} - \text{Taxes} - \text{Interest} - \\ &\quad \text{Extraordinary nonrecurring expenses} \end{aligned}$$

Asset Management Path

- Assets:

Economic Resources (e.g., inventory, buildings, computers, store fixtures) owned or controlled by a firm

- Current Asset and Fixed Asset

Current Assets = Cash + Account Receivable + Inventory + Other current assets

There are two types of assets, current and fixed.

Current assets are assets that, under normal circumstances, can be converted into cash within one year. Current assets for retailers consist primarily of cash, accounts receivable, and inventory of goods in inventory.

Accounts receivable are primarily the sums of money owed to the retailer by customers who have purchased merchandise on credit from the retailer. It is common

for these receivables to originate from a retailer's proprietary store credit cards, also known as in-house credit cards.

Fixed assets are assets that will take more than a year to convert to cash after being acquired. Buildings (if the retailer owns the store property rather than leasing it), distribution centers, fixtures (e.g., display racks), and equipment are the most important fixed assets in retailing (e.g., computers, delivery trucks).

Asset turnover is the product of net sales divided by total assets. When applied to the strategic profit model, it is a performance measure that evaluates how well the asset management component performs.

Inventory turnover is the sum of COGS over a given period of time, typically a year, divided by the average level of inventory at cost over that period of time. For retailers to calculate the average inventory level, they must first calculate the value of their inventory on each day of the year and divide that total by 365.

Learning Objective 3 – Analysis of Financial Strength

In this section, we will discuss measures that are used to assess the financial strength of retailers, specifically the likelihood that they will go out of business. Cash flow, debt-to-equity ratio, quick ratio, and current ratio are some of the financial measures available.

- Cash-Flow Analysis

Retailers need cash to meet their obligations — i.e., salary, rent, vendors, etc.

Making adjustments to net profit, which entails adding or subtracting differences in revenue and expenses that occur from one period to the next, is how cash flow is calculated.

Debt-Equity Ratio

The amount of short- and long-term debt owed by the retailer divided by the value of the retailer's owners' or stockholders' equity.

Current Ratio

The ratio of short-term assets to short-term liabilities is used to assess a retailer's ability to meet its short-term debt obligations, and it is calculated as follows:

Quick Ratio

“acid-test ratio”

Due to the fact that inventory is removed from the short-term assets, the test is more stringent. Unless a retailer has sufficient cash on hand to pay its short-term obligations, it cannot rely on inventory as a reliable source of immediate cash.

Learning Objective 4 – Setting and Measuring Performance Objectives

It is a necessary component of any organization's strategic management process to establish performance objectives. Performance objectives should include the following elements: (1) a numerical index of the desired performance against which progress can be measured, (2) a time frame within which the objective is to be achieved, and (3) the resources required to accomplish the objective.

It will be easier for retailers to gauge performance if they have specific goals in mind to which they can compare their performances.

Top-Down versus Bottom-Up Process

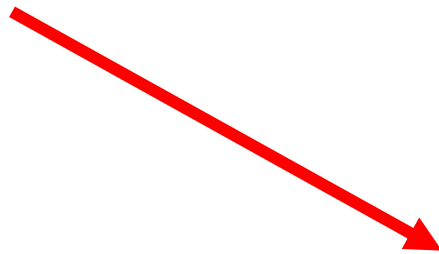
Setting objectives in large retail organizations entails a combination of the **top down** and **bottom-up** approaches to planning.

Top-down planning means that goals are established at the highest levels of the organization and then communicated to the lower operating levels. Top-down planning occurs in a retailing organization when corporate officers develop an overall retail strategy while also assessing broad economic, competitive, and consumer trends. They

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use this information to develop corporate performance objectives for the organization. Overall objectives are then broken down into specific objectives for each buyer and merchandise category, as well as for each region, store, and even department within a store and the sales associates who work in those departments. These specific objectives are then broken down even further.

Top-Down Planning
Corporate Developmental Strategy

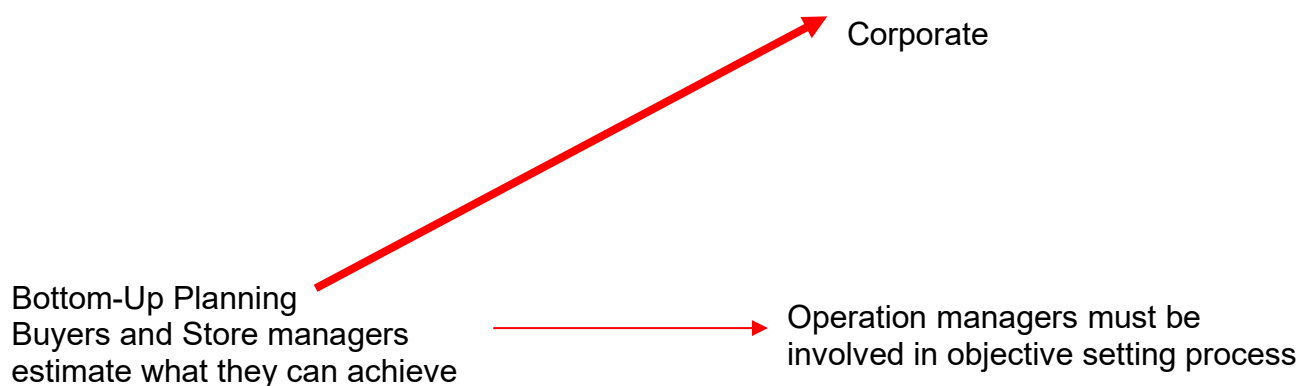


Category, Departments and sales
associates implement strategy

This top-down approach to planning is supplemented by a bottom-up approach to planning. When a company uses bottom-up planning, it means that employees at lower levels of the organization develop performance objectives that are aggregated to develop overall company objectives. Buyers and store managers make educated guesses about what they can accomplish, and these guesses are communicated up the corporate ladder to the corporate executives. There are frequently differences of opinion between the goals that have been communicated from the top of the organization and the goals that have been established by lower-level employees of the organization.

For example:

Because a major employer in the area has announced plans to lay off 2,000 employees, a store manager may not be able to achieve the 10 percent sales growth target set for his or her region. It is through a negotiation process involving corporate executives and operating managers that the differences between bottom-up and top-down plans are resolved. If the operating managers are not involved in the goal-setting process, they are less likely to accept the goals and, as a result, will be less motivated to achieve them in the future.



Asked Students:

Who Is Accountable for Performance?

Answer: It is important that business units and their managers are held accountable only for those aspects of the retail organization that they have control over, such as revenues, expenses, cash flow, and contribution to return on assets (ROA).

Example:

A store's performance objectives may include sales volume, sales associate productivity, store inventory shrinkage due to employee theft and shoplifting, and energy costs, among other measures. If a buyer lowers prices to get rid of merchandise,

and as a result, profits suffer, it is not fair to evaluate a store manager's performance solely on the basis of the resulting decline in store profit, as this would be unfair to the buyer as well.

Performance Objectives and Measures

here are numerous factors that influence a retailer's overall performance, making it difficult to identify a single metric to use to evaluate performance.

Example:

Sales are a broad indicator of the level of activity in a retail establishment. A store manager, on the other hand, could easily increase sales by lowering prices, but the profit realized on that merchandise (the gross margin) would suffer as a result of the price reduction. It goes without saying that attempting to maximize one measure may result in lowering another. It is therefore necessary for managers to understand how their actions affect a variety of performance measures. It's usually not a good idea to rely on a single measure because it rarely provides a complete picture.

It is dependent on (1) the level of the organization at which the decision is made as well as (2) the resources under the control of the manager as to which metrics are used to evaluate retail operations.

Types of Measures

Input Measures – assess the amount of resources or money used by the retailer to achieve outputs such as sales

Output measures – assess the results of a retailer's investment decisions

Productivity measure – determines how effectively retailers use their resource – what return (e.g., profits) they get on their investments (e.g., expenses)

Corporate Performance

Retail executives have three critical resources (inputs) to manage at the corporate level: merchandise inventory, store space, and employees. These resources (inputs) are necessary for them to generate sales and profits (outputs). In order to assess the utilization of these assets, effective productivity measures include asset and inventory turnover, sales per square foot of selling space, and sales per employee. As previously discussed, return on assets (ROA) is an overall productivity metric that combines the profit margin percentage and asset turnover management. Another commonly used metric for overall performance is comparable store sales growth (also known as same-store sales growth), which takes into account growth in stores that have been open for at least one year as a proxy for overall performance. Increases in sales can be achieved by increasing the amount of sales generated per store or by increasing the number of stores. Growth in same-store sales measures the first component of sales growth and, as a result, indicates how well the retailer is performing in terms of its core business concept. New stores do not represent an increase in sales over the previous year, but rather new sales generated in areas where there were no previous sales the year before. If same-store sales are declining, it indicates that the retailer's fundamental business approach is not being well received by its customers, even if overall sales are increasing as a result of the retailer opening more new stores.

Merchandise Management Measures

The merchandise inventory is the most important resource (input) under the control of merchandise managers. Managers have the authority to set initial pricing as well as to lower pricing when merchandise is not selling well (i.e., take a markdown). Finally, they enter into negotiations with vendors over the price of merchandise purchased.

Store Operations Measures

Retail store managers have complete control over two critical assets: their stores' use of space and their employees' supervision and management. Store operations productivity can be measured in a variety of ways, such as sales per square foot of selling space and sales per employee (or sales per employee per working hour, to take into account that some employees work part-time). Store management is also in

charge of keeping inventory shrinkage (theft by employees and customers) under control, as well as keeping the store in good working order and reducing energy costs (lighting, heating, and air conditioning). As a result, inventory shrinkage and energy costs as a percentage of sales are two other productivity measures that are used to evaluate the performance of retail store managers.

Assessing Performance: The Role of Benchmarks

As we have discussed, the financial measures used to assess performance reflect the retailer's market strategy.

Growth in Stockholder Value – Stock Price

Accounting Measures – ROA (Risk adjusted)

Benchmark

Performance Over Time

Compare performance indicator for three years

Performance Compared to Competitors

Compare performance indicators with major competitors for one year, most recent

To get a better assessment of a retailer's performance, we need to compare it to a benchmark. Two commonly used benchmarks are

(1) the performance of the retailer over time and

(2) the performance of the retailer compared with that of its competitors.

Performance over Time. When evaluating a retailer's performance, one useful approach is to compare the retailer's recent performance with the retailer's performance in the months, quarters, or years prior.

Performance Compared to Competitors A second approach to evaluating a retailer's performance is to compare the retailer's performance with the performance of its competitors in the marketplace.

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