

## 9.19: Sales, Costs, and Expenses

### Learning Objectives

- Define net sales, costs of goods sold, operating expenses

Understanding and being able to draw insights from the income statement is critically important for managers. Specifically, the four components that make up the profit management path are found in the income statement:

- Net Sales
- Cost of Goods Sold (COGS)
- Gross Margin
- Operating Profit Margin

Some of these components may be familiar to you from the previous sections, but we will go into more detail here. It's important that you have a good understanding of key terms and how they're used so that you can influence profitability for your organization.

To begin:

- Gross sales = total sales before returns, discounts, or allowances
- Net sales = gross sales – (returns + discounts + allowances)

Let's take a moment to consider how or why returns, discounts, or allowances occur. Certainly, returns are easily understood—product gets returned to vendors when merchandise is shipped in errors or has some defect. But, what about discounts or allowances? These can occur for a number of reasons. For example, a vendor might credit a customer (reduce their price) if:

- The retailer keeps the damaged merchandise, understanding that the retailer will likely have to reduce their own selling price to turn the inventory
- The retailer buys in bulk quantities, creating efficiencies for the vendor
- The retailer picks up the shipment at the warehouse, reducing the logistics costs for the vendor.

Similarly, a vendor might offer a discount on merchandise if bills are paid within a specific window. For example, 2% net 10 means the merchandise will be discounted 2% if the payment is received within 10 days.

You'll note, these examples tend to focus on allowances and discounts vendors make for retailers. But, retailers might have allowances of their own. For example, if a retailer offers a warranty on products, they'll discount their gross sales to reflect future warranty claims.

Other important terms to understand relate to the cost side of managing the business.

Cost of goods sold is the amount the retailer pays for the merchandise it sells. COGS does not include operating expenses of the firm, it is just the cost of merchandise sold. The cost of any unsold merchandise will be subtracted from COGS (ending inventory). This should make sense because the product is unsold and the firm holds the asset in its inventory.

Gross margin = net sales – cost of goods sold. This is generally expressed dollars, but can also be shown as a percentage (gross margin percent = gross margin dollars / net sales). As you read earlier, a retailer selling its goods for the same price it purchases it will immediately find it's running deficits. And, obviously, that is a very fast path to bankruptcy and closure. So, as an alternative, retailers sell their products at prices above cost.

Operating profit margin = gross margin – (operating expenses + extraordinary (recurring) operating expenses). Operating expenses are additional expenses of running the business like rent, utilities, labor costs, etc.

These concepts help us examine financial performance, providing insight on the business' revenues and expenses, which influence profitability.

### Practice Questions

<https://assessments.lumenlearning.co...sessments/9235>

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