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Produce Direct Product Profit Gives Added Value Information for Management

by

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Direct Product Profit concept is a management tool which, if fully understood and properly used, will increase the effectiveness of retail operations and merchandising.

What is Direct Product Profit (DPP) and why is it so important? The present standard method used in the retail industry to determine the profitability of an item is to calculate Gross Profit Dollars or Gross Profit Percentage. Gross Profit Dollars is obtained by subtracting the cost of the item from its selling price. Gross Profit Margin is the same as Gross Profit Dollar except there is an additional step of dividing the answer by the total selling price. This method of calculating how profitable an item is can be very misleading, because it does not take into consideration major cost factors such as warehousing, trucking, and store cost. The labor and shrink factor to handle different produce items can vary tremendously. That is the reason a Produce Direct Product Profit Computer Model is being developed.

Direct Product Profit is no different from what accountants call "cost accounting." It involves allocating those costs that are directly attributable to handling that commodity, item, S.K.U., etc. The result gives a far truer picture of the profitability of the item.

DPP will help management make better decisions about such factors as:

- determining if an item should be prepackaged
- how and where to prepackage an item (purchased or wrapped in store)
- method of delivery to store (warehouse vs. DSD)
- the value of buying quality merchandise
- pricing merchandise
- space allocations
- location of displays
- should one repack a slow selling item at the warehouse or pay a premium and buy a smaller shipping pack?

DPP can also be used in "What if" merchandising decisions. However, quality and image must always be taken into account when evaluating a product. DPP is a great tool, but it is not without some major pitfalls that could easily mislead management in its decision making. For example, management gets an impressive looking computer printout ranking the DPP for various items. What if the cost factors in the computer program are wrong? What then?

When using the DPP Produce Computer Model, it is more important than ever to have both accurate time values and shrinkage data by item. I know for a fact that one company is using in its Grocery Direct Product Profit Model the old prescanning time value for tray stocking. When it is not necessary to price the individual items for tray stocking, you can make a tray by cutting the top and front panel off the case, which is much faster than the old method. How often will the computer cost factors, other than the cost of merchandise, sale price and movement be updated? It has been my experience over the years that those items that are hidden are the last ones to be changed.

Another major concern I have with the improper use of DPP is if management forgets and thinks that DPP represents the breakeven point. Indirect costs are a very large and significant factor for warehousing, trucking and the stores. In a produce department, indirect labor alone can amount to approximately 30 percent. The following is a list of indirect cost factors that are not included in the DPP calculation.

Occupancy Costs

- Rent
- Utilities
- Building repairs
- Equipment rental

Misc. Occupancy Costs

- Property taxes, etc.
- Insurance
- Licenses
- Shopping center charges
- Indirect employee
- Telephone
- Laundry
- Garbage & trash
- Outside services
- Return checks
- Cash shorts

Store Indirect Labor

- Management
- Office help
- DSD receiver
- Scan file clerk
- Head cashier
- Carryout
- Cleaning and floor care
- Maintenance

Corporate Office

- Buyers
- Merchandisers
- Accounting
- Line management
- Advertising and promotion
- Overhead, rent, etc.
- Interest on inventories

The cumulative effects of adding up all of these indirect cost factors along with state and federal taxes can well be 10 percent of more of the selling price. By knowing what the indirect costs are, management can make better decisions.

In spite of these concerns, I would still strongly recommend the use of the Direct Product Profit Model. I believe DPP for produce will be used by the retailers once they are familiar with the model because it will give them a clearer and more accurate assessment of individual item performance.

The spread between direct handling cost for various produce items will be greater than those found in grocery DPP. The reason for the wider variation in costs is the difference in labor requirements and shrinkage among commodities. The tables that follow illustrate how DPP would help in making a decision about whether or not to buy wrapped iceberg lettuce. Included are indirect produce department costs for labor and overhead so the bottom line would appear more realistic. However, this illustration does not include the overall store indirect cost or state and federal taxes.

Cost of Iceberg Lettuce Naked Vs. Wrapped

	<u>Naked</u> (\$/ctn.)	<u>Wrapped</u> (\$/ctn.)	<u>%</u>
Cost Per Carton			
F.O.B. Salinas, CA	\$ 6.00	\$ 6.00	
Cooling charge	.65	.65	
Palletizing	—	.35	
Wrapping charge	—	1.50	
Sub-total	(6.65)	(8.50)	+28%
Trucking charge to N.Y.*	4.00	3.64	
TOTAL	\$10.65	\$12.14	+14%

***Price \$3,200 (\$3M-\$4M) Naked 800 ctn./, wrapped 880/ctn.**

Cost Comparison of Handling Costs For Various Methods of Selling Lettuce

<u>Cost Elements</u>	<u>Naked</u> (\$/ctn.)	<u>Store Wrap</u> (\$/ctn.)	<u>Source Wrap</u> \$/ctn.)
Whse., & Trans.	\$.50	\$.50	\$.50
Labor (direct)	1.78	2.22	.72
Labor (indirect)	.87	.87	.87
Shrinkage	.89	.44	.25
Wrapping material	.19	.31	.05
Checkout labor	1.20	1.00	1.00
Space cost, etc.	.75	.75	.75
TOTAL	\$6.18	\$6.09	\$4.14

Gross Profit Margin % For Iceberg Lettuce Before and After Handling Charges

	<u>Naked</u> (\$/ctn.)	<u>Wrapped</u> (\$/ctn.)
Retail Price / ctn. @ \$0.79 / head	\$18.96	\$18.96
Cost of Lettuce	\$10.65	\$12.14
Gross Profit	\$ 8.31	\$ 6.82
" " %	44%	36%
Handling Cost	\$ 6.09 *	\$ 4.14
Total Direct Cost	\$16.74	\$16.28
Direct Profit	\$ 2.22	\$ 2.66
" " %	12%	14%

*** Lettuce wrapped at the stores**