Understanding Retail Profit

Students need to understand the very small profit margin that sustains many retail firms. Most students do not stop and think about what a 3% - 5% profit margin really means. They seem to assume that if one opens a business charges a "huge" marked up price that profits automatically follow.

One way to demonstrate how slim retail margins are is to use real money and mock invoices for the expenses normally encountered. There is no better illustration of how difficult it is to hold onto cash and profits than to have your own money, your own expenses and then see the process unfold until you are left with the 3% margin that is near the industry norm.

For this illustration, use $100 in cash or play money and three student volunteers. The use of real money makes for a more dramatic demonstration. If you use play money, play with the understanding that the students can trade the play money profits for real cash at the end of the game. Two of the student volunteers act as partners in a small specialty retail firm. I ask for two students who are interested in the retail business and who want to sell me an item for $100 with the understanding that they can split the profits. The third student is the firm’s controller. Choose whatever product you like for the demonstration. Apparel items work well as the specialty store’s merchandise item because most students are interested in clothing.

The students come to the front of the room where I would buy an apparel item (i.e., a sports jacket) for $100 in cash. I give the $100 to one the two "partners" but at the same time I give the controller a "stack" of bills that have to be paid today. The controller is instructed to present the invoices in the following order to the partners, and of course, payment is made directly back to me. I use index card sized documents with large letters noting "Invoice" and the nature of the debt. These invoices and amounts are presented in order, as follows:

Cost of Merchandise	$50
Markdowns on Other Goods	$10
Advertising	$3
Rent	$10
Salaries and Wages (give $1 to the Controller)	$15
Insurance & Local Taxes	$2
Utilities	$2
Travel to Market	$2
Misc. Supplies (sacks, tickets, hangers)	$1
Shrinkage	$2

(The students should be left with $3 at this point)

Each invoice provides an opportunity to discuss a cost issue and possible strategic alternatives. For instance, Cost of Merchandise indicates only a 50% initial markup, perhaps the students should have tried for a higher markup. The markdowns on other goods and advertising can be used as an example of the "cost" of having a sale, and also perhaps the reason for their current customer’s store visit. While the cost of Rent, Salaries and Wages, Insurance, Utilities and Miscellaneous Supplies might be somewhat exaggerated, they demonstrate much of the unavoidable costs of a retail business. The Travel to Market and Shrinkage costs are deliberately high to demonstrate the need for control in the retail organization. Maybe on the next market trip our young business people will not stay at the Plaza Hotel in New York City. Also, they might work in the store more themselves to reduce the Salaries expense and to control Shrinkage better. Oh, by the way, do not forget to collect $1 in Federal Income Taxes from the students. This will leave them with a dollar each in profits. While this is well under industry norm, there are probably many small retail firms with years just like the one just demonstrated.