

9.11: Why It Matters- Financial Strategies in Retail

Distribution channels are the ways that products or services get to the end user and all the activities that bridge the producers with consumers. Distribution channels include:

- **Logistics:** assembly, warehousing, sorting, and transportation
- **Facilitation:** channel coordination, marketing, promotion, financing, and post-purchase service and maintenance
- **Transaction:** buying, selling, and the associated assumption of risk

These activities support the exchange of goods, transferring products and services to the consumer and transferring payments back to the producer. Some producers leverage intermediaries, like wholesalers and retailers, for facilitation and transaction activities.

This indirect channel is a very familiar because it's what we most frequently associate with retail, especially in the grocery industry. We understand that while the inclusion of intermediaries does add some complexity, it has two critical benefits.

First, this channel arrangement allows for the individual actors, producers, and intermediaries, to specialize, thereby increasing efficiency and reducing costs. Further, because of the exchanges throughout the marketing channel, risk is managed and mitigated. A producer does not own the entirety of their inventory as they try to sell products to individual consumers. Instead, they sell part of the inventory to a collection of wholesalers and retailers who undertake some risk and ultimately market the product to consumers. These wholesalers and retailers will realize greater revenue for the same product compared to the producer, but this is an appropriate offset for the risk of holding inventory.



How do the wholesalers and retailers realize greater revenue for the same product? And, why is it necessary to have an offset for the risk of holding inventory? Does this make sense?

Let's start with the first question, "How do the wholesalers and retailers realize greater revenue for the same product?"

Simply, they acquire the good at a lower cost than the price at which they ultimately sell it. Consider the example of a retailer that buys a case (24 units) of yogurt from the manufacturer for \$12.00:

- Wholesale Cost = \$12.00
- Wholesale Cost per Unit = \$12.00 divided by 24 units = \$.50 per cup ($\$12.00 / 24 = \$.50$)

If a retailer sold each cup for \$.50 per unit, then they'd create very big problems for themselves. That is, they would cover the costs of the product, but not the costs of rent, utilities, advertising, labor, and administrative costs, such as printing tags, managing inventory, and schedule staffing. In other words, they'd find themselves running deficits, meaning they were running their business at a loss. Not adding the additional costs to each is a very fast path to bankruptcy and closure.

So what is the alternative?

Retailers sell their products at prices above cost. This difference is called **gross margin** and is used to absorb the cost of running a business. Let's look again at our yogurt:

- Wholesale Cost = \$12.00
- Wholesale Cost per Unit = $\$12.00 / 24 = \$.50$ per cup

Now add the additional costs:

- Retail Price = \$.79 per cup
- Gross Margin Dollars = $\$.79 - \$.50 = \$.29$
- Gross Margin Percent = $\$.29 / \$.79 = 36.7\%$

Now, \$.29 per selling unit of yogurt may not seem like much, especially in the face of rent, utilities, advertising, labor, and administrative costs. And, in truth, it isn't when you consider that the store is making margin on almost every single item that is

placed in the shopper's basket, scanned through the register and carried out of the store. It's the margin on each of these items that keep the store in business.

Now, for the second question: "Why is it necessary to have an offset for the risk of holding inventory?"

As we noted above, retailers incur a number of different operating expenses, but, there are also risks associated with holding inventory, including spoilage, damages, and slippage or theft. That is, in the grocery industry products can spoil or age past their "Best If Used By" dates. If this occurs, the value of the product in inventory goes to \$0.00. Simply, it can't be sold and has no commercial value, regardless of what the retailer paid for it.

Another consideration is to think about the complexity of the retail supply chain, where product is held in cartons, stacked on pallets, and stored in warehouses before it makes its way to the selling floor. Accidents happen. Pallets tip, spilling their wares. Forklifts back into product, making it unsaleable. Customers drop products and they sometimes dent cans and boxes. In many cases, this damaged product cannot be sold to consumers because it is no longer attractive to consumers. In these cases also, its commercial value is \$0.00.

The same is true for **slippage**, the difference between the expected price and the actual price received. This can occur when items are mis-tagged, mis-scanned, or under-valued in some other way. This doesn't imply that the commercial value is \$0.00. Instead, it simply reflects that the retailer did not realize 100% of the commercial value that they would have expected. In the same way, theft prevents the retailer from realizing the commercial value of the goods.

Flood, fire, and obsolescence are other areas of risk associated with holding inventory. As you can see, these all create situations where the commercial value of goods can be impaired. For our purposes, let's consider another factor—lost opportunity. That is, if we have some portion of our financial resources tied up in the cost of inventory, we may not be able to take advantage of other more attractive opportunities.

Let's think again about our yogurt example.

Instead of a purchase of a single case of product, let's expand to buy enough inventories to support 70 stores for one month. And, for the sake of this exercise, let's assume that each store sells two cases of this type of yogurt per week.

- Weekly Volume = 2 weeks x 24 Cups x 70 Stores = 3,360 Cups
- Monthly Volume = 4 weeks x 3,360 = 13,440 Cups
- Total Cost of Goods = 13,440 x \$.50 Wholesale Cost = \$6,720.00
- Total Revenue = 13,440 Cups x \$.79 Retail Price = \$10,617.60
- Gross Margin Dollars = \$10,617.60 Total Revenue – \$6,720.00 Total Cost of Goods= \$3,897.60

This means that we'd spend \$6,720.00 to make \$3,897.60 in gross margin dollars. This may sound good, but, what if we could've spent the same to make \$4,500 in gross margin dollars? \$5,000? \$6,000?

Because we had already invested \$6,720.00 for yogurt, those dollars weren't available to buy other items. While we held the inventory and waited for the items to sell to return gross margin dollars to us, we were unable to consider other opportunities—opportunities that might have been more attractive. This is one of the risks associated with holding inventory.

You might wonder, how do retailers know the right prices to charge to ensure they're able to manage operating costs and mitigate risk associated with holding inventory?

Unfortunately, there isn't one answer that'll work perfectly for all situations and strategies. Instead, it's important for retail managers to be familiar with the concepts of accounting, and to be able to read and analyze financial statements.

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