

“Dare to beprice aware”

Double your profits

Try this with your own figures ...you may be very surprised!

For many companies that I have dealings with, the management of price is diffused at best and chaotic at worst. Pricing decisions are often taken at different levels of the organisation - accountants, general managers, marketing and field salesmen - with little understanding of the true impact that changes in prices actually have on the profitability of the company.

During hard times, like now, cost control becomes central to most business activity and there has been enough written about that so I will not provide anything more here.

However, I have also noticed that many companies often have a collective desire to search for sales growth as an antidote to cost control and they use lower prices as the main lever to seek additional sales volumes and to ease the problems that they are having.

Pricing decisions are so important that poor decisions can lead to disaster and are often based on the simple premise that if prices are lower people will buy more (possibly true of commodities but not necessarily so where products are differentiated by design, advertising, brands, sales pressures, perceived quality differences etc.)

Pricing decisions are often taken arbitrarily. They are often based on firm estimates of costs (the actual "cost" of a product is worthy of another discussion) but very uncertain estimates of the market and how people/buyers will behave. They are interfered with by managers down the line through extra concessions and discounts for certain customers.

I encourage you to look at the following example (see diagrams below) of a fictitious business that has a turnover of £10m. It has a gross profit of £4m after deducting direct costs for materials and direct labour. Overheads - including accounts, management, sales, marketing etc are £3.5m leaving the company with a net profit of £0.5m

If this company wanted to **double its profits** it would take a 25% increase in sales volume (for example by selling a new product range that doesn't take sales away from existing products), a 14.3% reduction in fixed costs, or a 5% increase in price (by training salesmen how to negotiate, change product mix etc.)

As you can see a small percentage change to the price has a much more significant impact on profitability than changes in sales volume or cost control.

Then look at then pricing example and see what a 5% reduction in price has on the same business if the "well meaning" increase has no effect of sales volumes or "only" increase volume by say 5% or 10%.

And just remember this the next time the sales or marketing team demand a 10%, 20% or even 30% reductions in order to be psychologically significant enough to change buyer behaviour!!!

<p>Current business T/O £10m</p>	<p>Increase SALES 25% T/O £12.5m</p>	<p>Reduce Fixed costs 14.3% T/O £10m</p>	<p>Increase Price 5% T/O £10.5m</p>
<p>Direct Costs £6m (£6/unit)</p> <p>£4m Materials</p> <p>£2m Direct labour</p>	<p>Direct Costs £7.5m (£6/unit)</p>	<p>Direct Costs £6m</p> <p>£4m Materials</p> <p>£2m Direct labour</p>	<p>Direct Costs £6m</p> <p>£4m Materials</p> <p>£2m Direct labour</p>
<p>Fixed Costs £3.5m</p> <p>Fixed costs, overheads, sales, marketing, management, distribution</p>	<p>Fixed Costs £3.5m</p> <p>Fixed costs, overheads, sales, marketing, management, distribution</p>	<p>Fixed Costs £3.0m</p>	<p>Fixed Costs £3.5m</p>
<p>Net Profit £0.5m</p>	<p>Net Profit £1.0</p>	<p>Net Profit £1.0m</p>	<p>Net Profit £1.0m</p>

PRICE REDUCTION EXAMPLE

Example to show what a 5% reduction in price has on the same business if a “well meaning” reduction has no effect of sales volumes or “only” increases volume by say 5% or 10%.

The “current” business sells 1,000,000 million items at an average selling price of £10 each = T/O £10m

<p>Direct Costs £6m (£6 per unit) £4m Materials£2m Direct labour</p>
<p>Fixed Costs £3.5m overheads, sales, marketing, management, distribution</p>
<p>Net Profit £0.5m</p>

REDUCE Price 5% - price would now be £9.50

Increase in sales volume by 10% to 1,100,000

TOTAL SALES £10.45m (1.1m items @ £9.50)

Direct Costs £6.6m (£6/unit)
Fixed Costs £3.5m Fixed costs, overheads, sales, marketing, management, distribution
Net Profit £0.35m

Now assuming the same price reduction only got a 5% increase in volume

REDUCE Price 5% - price would now be £9.50

Increase in sales volume by 5% to 1,050,000

Total sales £9,975,000 (1.05m items @ £9.50)

Direct Costs £6.3m
Fixed Costs £3.5m Fixed costs, overheads, sales, marketing, management, distribution
Net Profit £0.2m

Now assuming the same 5% price reduction got a 0%
increase in volume

REDUCE Price 5% - price would now be £9.50

Sales volume will still be 1,000,000

Total sales value:£9,500,000 (1.0m items @ £9.50)

Direct Costs £6.0m
Fixed Costs £3.5m Fixed costs, overheads, sales, marketing, management, distribution
Net Profit £0.0m

What conclusions would you draw from this?

What increase in sales do you need to maintain profits? (FYI – in the example the company needs nearly a 15% increase in sales to produce the same profits as before following a 5% price reduction – and this assumes no overhead increases e.g. marketing expenditure or overtime etc !!!!)

Start by doing the same analysis for your business.

Alternatively call me and we can start to look at pricing policy, marginal costing decisions, standard cost pricing, cost-plus pricing, sales negotiations, sales force training, price increase strategies.

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