Understanding The Relationship Between Price Changes and Sales

Way #115

Business leaders must avoid the trap of doing things simply because "that's the way it's always been done." Decision makers must also avoid changing just for the sake of changing. The situations facing owners and decision makers in today's economy require careful and calculated analysis before making a decision.

How to price a product is a frequent pitfall for business decision makers who often give pricing policies very little in-depth thought.

Impulsive decisions are often made to decrease prices without an understanding of the additional sales necessary to increase profitability. The other side of the coin is that many businesses are reluctant to raise prices because they fear a decrease in sales.

Let's look at a chart that illustrates the effect that gross profits have on sales.

Pricing Matrix

On the Pricing Matrix in the box to the right, look under the column closest to your organization's gross profit percentage and the row corresponding to your projected price increase or price decrease. The percentage computed where the column and row meet illustrates how much the percentage sales may decline or increase in order to break even.

It is important for you to understand the basis for computation in this chart so you will be able to re-compute the percentage in specific ranges for your organization. To illustrate how the computation is made, let's look at the following example.

	Dollar	Percentages
Sales	$1,000,000	100%
Cost of Sales	$ 550,000	55%
Gross Profit	$ 450,000	45%

Now let's assume you wish to increase your gross profit to 50%. You must work the computation in reverse. Gross profit plus cost of sales equals sales. Therefore, if your financial goal is gross profit of $450,000, by increasing your gross profit percentage to 50%, cost of sales would be $450,000 (50% of sales). Sales would be the sum of gross profit $450,000 plus cost of sales $450,000 totalling $900,000.

Therefore, if prices increase 5%, sales can decrease 10%, and gross profit will remain the same!

Now look at the chart - under the 45% column, and the 5% price increase row, find the percentage that relates to both elements of financial data, - 10%. That is the same percentage as computed in the previous example.

A short-cut formula for computing sales necessary to breakeven if gross profit is changed is as follows:

$$\frac{\text{Gross Profit in Dollars}}{\text{Gross Profit as a Percentage}} = \text{Sales Needed to Break Even}$$

Let's test this formula using the preceding example:

Pricing Matrix

			Gross Profit Percentage						
			20%	30%	45%	50%	60%	70%	80%
			Sales can decline by as much as:						
Price	↑	5%	-20%	-14%	-10%	-9%	-8%	-7%	-6%
	↑	10%	-33%	-25%	-18%	-17%	-14%	-13%	-11%
Increase	↑	15%	-43%	-33%	-25%	-23%	-20%	-18%	-16%
	↑	20%	-50%	-40%	-31%	-29%	-25%	-22%	-20%

			Gross Profit Percentage						
			20%	30%	45%	50%	60%	70%	80%
			Sales must increase by:						
Price	↓	5%	33%	20%	13%	11%	9%	8%	7%
	↓	10%	100%	50%	29%	25%	20%	17%	14%
Decrease	↓	15%	300%	100%	50%	43%	33%	27%	23%
	↓	20%	N/A	200%	80%	67%	50%	40%	33%

Illustration

Gross Profit	$ 450,000	50% of sales
Cost of Sales	450,000	50% of sales
Sales Necessary to Achieve Financial Goal	900,000	100%
Actual Sales Prior to Increase in Gross Profit Percentage	1,000,000	
Projected Decrease in Sales to Break Even	(100,000)	
Decrease in Sales to Break Even	(100,000)	
Actual Sales Prior to Change in Gross Profit Percentage	$ 1,000,000	= 10% (amount in chart under column 45% and row-Price Increase 5%)

$$\frac{\$\,450{,}000}{50\%} = \$900{,}000 =$$

Sales Needed to Break Even

This is the same amount, $900,000, as sales computed in the previous illustration.

Now that you understand the computations, you can prepare a matrix illustrating the sensitivity of price change to sales, specifically for your business. As you begin to analyze your newly prepared matrix, you will be surprised at how much additional business you will need to breakeven after cutting prices. The opposite is true as well - by increasing prices, you will probably not experience a loss of business greater than will break you even! Your company will be more profitable after the increase, even with a shrinkage in volume.

This is also an example of traps to avoid and the problems that can result when owners and managers are not trained to look beyond the obvious. Participation in 100 Ways™ workshops teaches decision makers to look at situations with open eyes and to apply new thinking to old and new circumstances alike.

Study these principles, they are a key ingredient to your business and financial success.

STRATEGY FOR PRICE CHANGES

How Does This Apply To My Business?

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Priority 1 2 3 (Circle one)

Action Date: ____________

Potential dollar effect: $__________

Person assigned to this strategy:

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stellar service when solicitations without merit are requested.

When future calls come in for Harvey Overclutch, the operator knows to inform the parties that he is sick, on vacation or merely out of the office. After several unfruitful attempts the pushy caller typically loses interest, to the benefit of our client.

Harvey's employer often receives mail for Harvey Overclutch as well. The office manager who sorts and distributes mail knows to toss Harvey's in the dead file.

Considerable dollars have been saved because of Harvey Overclutch. Time is precious and when there are unnecessary distractions, worthwhile projects suffer. Wasted time comes in part from meetings that lack purpose, and mail that is unnecessarily read. Perhaps Harvey offers a practical solution in assisting with enhanced productivity within your organization. His price is right!

STRATEGY FOR HIRING HARVEY OVERCLUTCH

How Does This Apply To My Business?

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Priority 1 2 3 (Circle one)

Action Date: ____________

Potential dollar effect: $__________

Person assigned to this strategy:

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