Guide: Pricing and Profit

Price setting is complex, just as important as market awareness, product development and advertising. You could do all these things excellently and then undo it all on the price.

Pricing is one of four specific factors which determine your profit and it's one you have some control over. Let's step back for a minute and think about profit.

What is profit?

Profit is residual.

Profit is "'what's left over'". In other words: residual. It is the consequence of what happens in and to your business. Some of these things are within your control and some of them are outside your control. Profit is what's left over after you've paid all your expenses.

Four specific factors

If you're going to have any effect on your profit you have to focus on those things over which you have control.

So, what are they? There are only four specific factors, which determine your profit. These are:

1. The price you charge for the products and/or services you sell.
2. The quantity (or volume) of products and/or services you sell.
3. The costs you incur directly in producing or buying the products and services you sell. We call these variable costs because they increase and decrease as your sales increase or decrease.
4. The costs you incur whether you make any sales or not. They are best described as fixed costs because they do not change in sales volume, at least not on a day-to-day basis.

Let's put these four things together. In the example below, for simplicity, we'll assume you only have a single product, but the conclusions we come to will apply whether you have 1 or 1,000 products.

Suppose you sell a widget. It costs you $60 and you sell it for $100. What you sell the widget for is the price. What you pay for it is a variable cost. If you sell 100 widgets your total variable costs will be $6,000 whereas if you sell 50 widgets, the total variable cost is only $3,000. It varies directly with your sales volume. Now, if you sell a widget for $100 and it costs you $60 then you've made a profit of $40 on each sale. We call this the gross profit or gross margin. We monitor it to remind us that we still have to meet our fixed costs before we end up with a net profit.

If you sell 100 widgets and make a gross margin on each one of $40, then your total gross margin is $4,000 and if your fixed costs for such things as rent, leases, wages, insurance, etc amount to $3,000 then you end up with a "net profit" of $1,000. On the other hand, if your fixed costs are more than $4,000 then you'll incur a loss.

The key takeaway here is that if you're thinking about your pricing, look at it in the overall context of improving your profitability.

Improving your gross margin

Your gross margin is the difference between the price of your product and what it costs you to buy or make it. Therefore, the only way to increase your gross margin is to sell at a higher price or buy at a lower price.

In most instances (but not all!) you will have limited scope to buy at a lower price. So, your selling price is the critical variable.

Without doubt, the biggest single barrier preventing small business managers from making an acceptable profit is their refusal to charge a price that will enable them to achieve this. You are not in business to match the price your competitors set: you are there to service your customers.

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Studies of the factors people regard as important in their decision to deal with a particular business indicate that product and price are relevant in only 15% of cases.

Trying to hold or win market share based on price discounting can be a lazy manager's competitive strategy. It is applicable in only one situation: where you have a definite cost advantage (either variable or fixed) over your competitors and your product or service is one where customers are very price sensitive.

Should you discount or increase prices?

When considering whether to increase or decrease your prices, look at it in relation to gross margin and sales volume. Consider the following examples of how pricing shifts could affect business. Could you make other changes to balance out any downturn and sustain your margins?

Should you be discounting your price?

The following table indicates the increase in sales required to compensate for a price discounting policy. For example, if your gross margin is 30% and you reduce the price by 10% you need sales volume to increase by 50% to maintain your profit. Rarely has such a strategy worked in the past and it's unlikely that it will work in the future. Look at your gross margin and focus on the discount you've been considering. Run the numbers and look at what's workable for your business.

If your present gross profit rate is:

	5%	**10%**	**15%**	**20%**	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**	**55%**	**60%**
Discount by:	**To produce the same profit your sales must increase by:**											
2%	67%	25%	15%	11%	9%	7%	6%	5%	5%	4%	4%	3%
4%	400%	67%	36%	25%	19%	15%	13%	11%	10%	9%	8%	7%
6%		150%	67%	43%	32%	25%	21%	18%	15%	14%	12%	11%
8%		400%	114%	67%	47%	36%	30%	25%	22%	19%	17%	15%
10%			200%	100%	67%	50%	40%	33%	29%	25%	22%	20%
12%			400%	150%	92%	67%	52%	43%	36%	32%	28%	25%
14%				233%	127%	88%	67%	54%	45%	39%	34%	30%
16%				400%	178%	114%	84%	67%	55%	47%	41%	36%
18%				900%	257%	150%	106%	82%	67%	56%	49%	43%
20%					400%	200%	133%	100%	80%	67%	57%	50%
25%						500%	250%	167%	125%	100%	83%	71%
30%							600%	300%	200%	150%	120%	100%

Should you be increasing your prices?

If you adopt a premium pricing strategy, the following table shows the amount by which your sales would have to decline following a price increase before your gross profit is reduced below its present level. For example, at a 40% margin, a 10% increase in price could sustain a 20% reduction in sales volume. Run the numbers and look at what's workable for your business.

If your present gross profit rate is:

	5%	**10%**	**15%**	**20%**	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**	**55%**	**60%**
Price increase:	**To produce the same profit your sales may reduce by:**											
2%	29%	17%	12%	9%	7%	6%	5%	5%	4%	4%	4%	3%
4%	44%	29%	21%	17%	14%	12%	10%	9%	8%	7%	7%	6%
6%	55%	38%	29%	23%	19%	17%	15%	13%	12%	11%	10%	9%
8%	62%	44%	35%	29%	24%	21%	19%	17%	15%	14%	13%	12%

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10%	67%	50%	40%	33%	29%	25%	22%	20%	18%	17%	15%	14%
12%	71%	55%	44%	38%	32%	29%	26%	23%	21%	19%	18%	17%
14%	74%	58%	48%	41%	36%	32%	29%	26%	24%	22%	20%	19%
16%	76%	62%	52%	44%	39%	35%	31%	29%	26%	24%	23%	21%
18%	78%	64%	55%	47%	42%	38%	34%	31%	29%	26%	25%	23%
20%	80%	67%	57%	50%	44%	40%	36%	33%	31%	29%	27%	25%
25%	83%	71%	62%	56%	50%	45%	42%	38%	36%	33%	31%	29%
30%	86%	75%	67%	60%	55%	50%	46%	43%	40%	38%	35%	33%

Summing up

The foundation of an effective pricing strategy is the gross margin you need to achieve to be profitable. Work out the likely impact of upward or downward movement in your prices on gross margin. Factor in your competitors, their pricing and profile in the marketplace. And think about your customers, how well you service them, whether they're price sensitive and whether you can offer them more or attract more like them to your business.

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