Contact: jvajda@sgllp.com (508) 757-3311 ww.sgllp.com

Cutting Prices Can Be Dangerous!

By Joseph J Vajda, MBA

During tough economic times, there is an urge to reduce prices. In certain situations, it can be an effective strategy. Lower prices might entice customers to visit your business and buy more of the item or buy other goods. So, in the short term, it could help your current bottom line and help create traffic and activity. Price cutting is also called for in urgent turn-around situations where it is a necessity to drive in cash. But in most other cases, without a well thought out plan, it can be dangerous to a business's long-term survival.

As a strategy in tough economic times, cutting prices can be dangerous. Price cuts eat away at your margins. Without a compensatory decrease in the cost of providing your product or service, the only other way to maintain your margin is to sell more. In a down economy with reduced demand for most products and services, increasing sales can be a monumental task. And it may surprise some of you how much you need to increase sales to offset a cut in your prices.

The table on the following page shows the increase in sales that is required to compensate for a price cutting policy for a selected gross margin. For example, if your gross margin is **30%** and you reduce your prices by **10%**, you need your sales volume to increase by **50%** to maintain your initial gross profit. Rarely has such a strategy worked in the past, and it is unlikely that it will work in the future.

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If your present gross margin is…

To produce the same exact gross profit, you must increase your sales volume by…

If you cut prices by…

	20%	**30%**	**40%**	**50%**	**60%**
2%	11%	7%	5%	4%	3%
4%	25%	15%	11%	9%	7%
6%	43%	25%	18%	14%	11%
8%	67%	36%	25%	19%	15%
10%	100%	**50%**	33%	25%	20%
12%	150%	67%	43%	32%	25%
14%	233%	88%	54%	39%	30%
16%	400%	114%	67%	47%	36%

Besides the potential adverse impact on margins, a price cutting strategy may lead to other problems. A price cut focuses the customer's attention on your price. If price is your only competitive advantage, you are in trouble because price can be matched by almost any competitor. Also, price discounts can effect the customer's perception of the value of your product or service – the 'you get what you pay for' syndrome. The less a customer pays, quite likely the less they will value your product or service.

So if you are thinking about cutting prices, think long and hard about it, as thoughtless price discounting is an easy way to lose money fast.

If you need help in putting together a pricing strategy to meet both the short-term and long-term goals of your business, our team of Shepherd & Goldstein consultants is here to help. Please contact Joe Vajda at jvajda@sgllp.com or at 508-757-3311 to learn more.

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