Making Supplier Price Reductions Profitable

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One of the major pricing challenges facing distributors is in dealing with supplier price changes. Most of the changes recently are price increases. However, there are still many opportunities to purchase some products at a lower price when suppliers face end of quarter or end of year sales challenges.

This report will review the economics of short-run supplier price reductions. The next PIR will address the issue of perpetual price increases. The two challenges require very different strategies.

This report examines the supplier price reduction opportunity for distributors from two perspectives:

- **The Profit Impact—**An analysis of how a specific supplier price reduction can cause profit to either increase or decrease.
- **Behind the Profit Impact—**An examination of the specific actions that erode the profit potential associated with supplier price reductions.

The Profit Impact

Exhibit 1 demonstrates the impact of a supplier price reduction under two different scenarios. The exhibit represents performance for an illustrative distributor. As can be seen in the first column, the typical firm generates $20.0 million in sales, operates on a gross margin of 25.0% of sales and produces a bottom-line profit of 2.5 % of sales or $500,000.

In thinking about price reductions, it is essential to understand fixed and variable expenses. Fixed expenses are overhead costs which tend to remain constant regardless of sales volume. Variable expenses are items that rise and fall with sales, such as commission, bad debts and interest on accounts receivable.

For the typical firm, variable expenses are estimated to be 5.0 of sales or $1,000,000 on $20.0 million of sales. Fixed expenses are $3,500,000.

Two different supplier price-reduction scenarios are presented in the exhibit. Both reflect a reduction large enough to increase the firm's gross margin by 0.5 percentage points. The result is that the gross margin increases from 25.0% to 25.5% of sales.

For demonstration purposes the change in the gross margin is shown for the entire firm. Any change in prices by an individual supplier would follow the exact same pattern shown in the exhibit.

The first scenario, labeled *Buying Lower*, is straightforward. The firm purchases the same quantity of merchandise for a price that is $100,000 lower which results in the 0.5 increase in the gross margin percentage previously mentioned.

The result is that the reduction in Cost of Goods flows right to the bottom line. This is because fixed expenses remain the same and variable expenses remain 5.0% of the same sales volume. With no expense increase all of the impact from buying better results in a commensurate impact on profit.

The column labeled *Selling Lower* outlines the profit impact if outbound prices are reduced by the same percentage as the inbound supplier prices. Specifically, when Cost of Goods was lowered in the middle column from $15,000,000 to $14,900,000 it was a reduction of 0.67%. The sales number in the last column has been reduced by that same percentage.

The result of this action is to keep the gross margin percentage right where it was originally, 25.0%. However, since this gross margin is being applied to a lower sales volume, gross margin dollars actually fall from $5,000,000 to $4,966,667, the same percentage reduction as in sales volume.

There is some expense relief as the variable expenses are 5.0% of a lower sales number. However, the fixed, or overhead, expense remain constant. The result is that profit falls to $473,333, a 5.3% decrease from the original profit figure. It also represents a significant 21.1% decrease from the profit produced in the *Buying Lower* column.

Behind the Profit Impact

Clearly, the economics of buying and selling point to generating the higher profit on the inbound side and avoiding the reduction on the outbound side. The reality is that changes in distribution operations have made control of outbound prices in such situations more difficult.

Distributors have made outstanding progress in refining their information systems to eliminate what were once very human, but very time-sensitive decisions. Pricing changes can now be automated without the need for human intervention. However, the move from high touch to high tech may not always be beneficial.

When the supplier’s new lower price is recognized by the computer system it is automatically input into the item master file. Unfortunately, the fact that the price reduction is temporary may not be noted.

The computer, operating at the speed of light, recognizes the lower price and surmises that the correct gross margin percentage for this item is still 25.0%. It then lowers the outbound price accordingly. This allows the firm to maintain its exact gross margin percentage position.

It also allows the firm's entire information system to function. Suppliers are paid based upon the price they charged the distributor. Everything flows through the system properly. The only minor problem is that profit falls.

This is but one example that cries out for rethinking the high tech/high touch interaction. A competent buying staff must have the ability to override the cost of goods for sales and margin generation purposes.

A sophisticated computer system is "helpful," but not essential in generating gross margin slippages. The firm could have very easily decided that since they had purchased the product more cheaply this would be a great opportunity to show customers how competitive the company can be. That scenario would also provide the opportunity for a 0.67% reduction in the firm's price and the accompanying reduction in profit.

Moving Forward

Temporary supplier price reductions provide an important opportunity for distributors to generate what is commonly called "inside gross margin." Systems must be in place to ensure that the margin opportunity is achieved.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His two latest books, ***Breaking Down the Profit Barriers in Distribution*** and ***Profit Guide for the Small Distributor***, are available online at Amazon and Barnes & Noble.

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Exhibit 1
The Profit Impact of Buying Lower and Then Selling Lower
For a Typical Distributor

Summary Income Statement--$	**Current Results**	**Buying Lower**	**Selling Lower**
Net Sales	$20,000,000	$20,000,000	$19,866,667
Cost of Goods Sold	15,000,000	14,900,000	14,900,000
Gross Margin	5,000,000	5,100,000	4,966,667
Variable Expenses	1,000,000	1,000,000	993,333
Fixed Expenses	3,500,000	3,500,000	3,500,000
Total Expense	4,500,000	4,500,000	4,493,333
Profit Before Taxes	$500,000	$600,000	$473,333

Summary Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	75.0	74.5	75.0
Gross Margin	25.0	25.5	25.0
Variable Expenses	5.0	5.0	5.0
Fixed Expenses	17.5	17.5	17.6
Total Expense	22.5	22.5	22.6
Profit Before Taxes	2.5	3.0	2.4