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**PHASE FIVE [NEW00142.GIF](INTRODUCTION.docx)**

**EXERCISE TEN-B** House Information

**This exercise should be answered using the Phase 5 Variables Worksheet**

**[](variables5.xlsx)**

**Evaluating the Impact of a Price Decrease**

Fred mentioned to Anne if a price increase of 10% were to be profitable (see exercise 10-A) then shouldn't they also consider what might happen if they dropped prices by 10%? Under this scenario the product cost of goods sold as a percent of sales would be 65.00%, the freight cost as a percentage of sales would be 2.22%, and the inventory shrinkage cost would be 1.67%. It is expected that the gross margin return on sales would be 31.11%.

Fred argued that with a 10% price decrease that the average number of items purchased would go up by at least 20%. Anne disagreed because she felt that customers would not notice a 10% price decrease. She felt that if prices went down 10% that at most the average number of items purchased would rise by 12%.

The Variables Worksheet you will need to run this simulation can be reached by clicking the red “5” above. You will need to enter the changes on the Input Form one at a time. The financial statements and ratios will automatically be updated and shown on the bottom of the input form. You must then copy the revised income statement and ratios to the scenario columns on the Answer Sheet. This process will have to be repeated if there is more than one scenario described in the exercise. Instructions for use of the Variables Worksheet can be reached by clicking on the “Help” button at the top right of the worksheet. Be sure to save your work and print a copy once you are satisfied with its correctness. After you complete your simulation there are questions you need to answer. These can be answered by typing your responses below the questions, saving your work, printing a copy, and handing it in to the instructor if required.

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**EXERCISE TEN-B**

**QUESTIONS**

1. Evaluate the financial impact of the proposed price decrease.
2. What other considerations should be taken into account other than the impact on closure of the proposed price decrease? Why are these other considerations important?
3. Why does a seemingly logical strategy, like lowering prices to increase sales, have such a negative impact on profitability?
4. What risk does *The House* take by lowering prices in an attempt to increase profits?