LAP

Leadership, Attitude, Performance...making learning pay!

Risk Rewarded

Factors Affecting Profit

Objectives

A Explain the importance of profit in a private enterprise system.

B Describe factors affecting profit.

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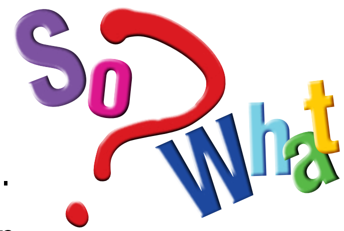


Have you ever...

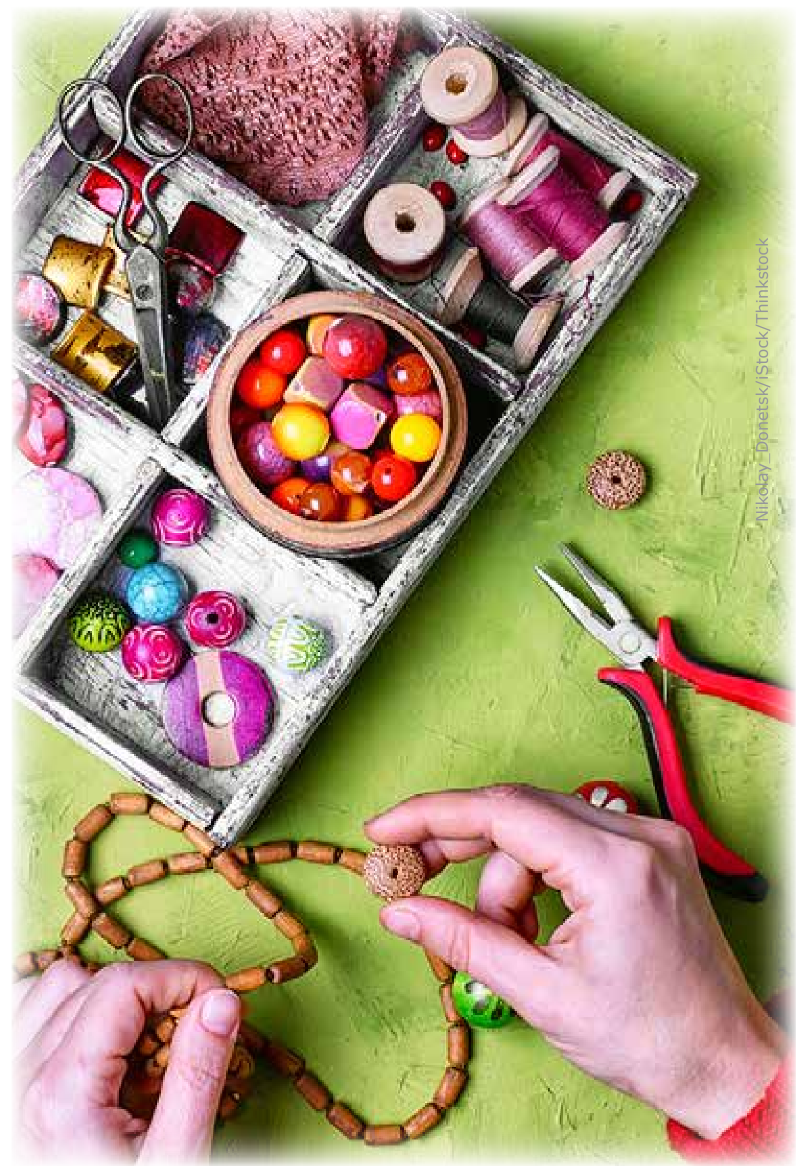
- Trained for an athletic competition?
- Studied hard for a test?
- Learned to play an instrument?

If you have, you've put your time and effort into something so you could get the reward: placing well at the competition, getting a good grade on the test, or performing well in the music recital. To get the reward, you had to give up something—your time, your energy, or even some of your money. So, before you decided to go for it, you considered whether the reward would be enough. You thought about what you'd gain compared to what you'd give. You asked, "Is it worth it?" If you answered "yes," you were expecting something in return for your effort—a profit.

How Much Is Enough?

Imagine that your favorite hobby is making jewelry. Since your friends have complimented you on your handmade jewelry in the past, you've decided to design and sell bracelets to your classmates and teachers. To prepare for the sale, you've spent long hours creating bracelet designs, purchasing supplies, and making the bracelets. In all, you've made 50 bracelets of varying sizes, colors, and materials. And now, you're ready to start selling your jewelry.

But will the time spent making the bracelets pay off? And, how can you tell if the money you receive is enough to cover your costs?



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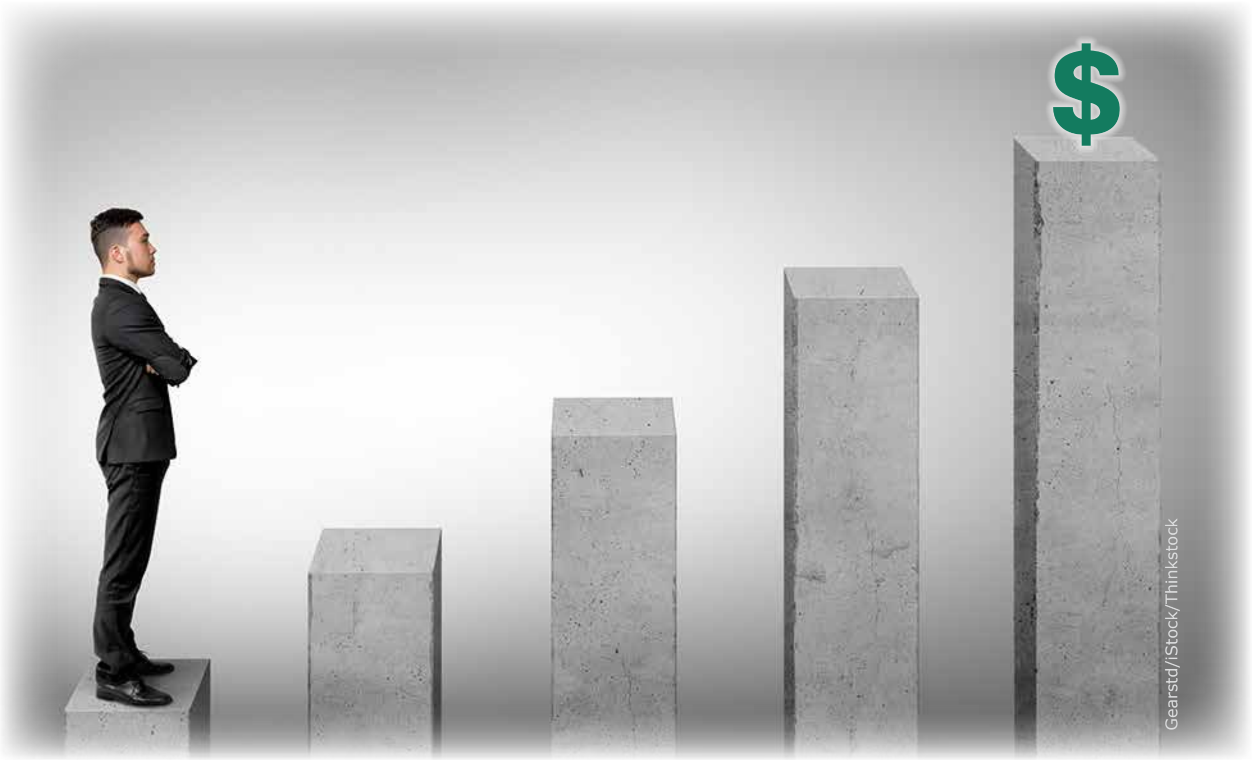
What Profit Is

If you're like most people, you want to receive something for your efforts. You don't want to spend time, energy, and money on a project without some kind of reward.



In business, when a reward is measured in financial terms, it's called profit. **Profit** is the monetary reward a business owner receives for taking the **risk** involved in investing in a business. It's what a business owner gets in return for putting money, time, and effort (or skill) into the business.

Business owners calculate profit using a simple formula:

Income – Expense = Profit

In other words, as soon as business owners total the firm's yearly income (the money that flows into a business), they subtract everything spent for production, sales, and administration. For instance, if they purchased materials, paid for labor, or flew staff to sales meetings, they subtract the cost from the total income received. The result is the leftover income—or profit—that business owners can use.

If, for some reason, **expenses** are greater than income, there's no profit. Having no profit is an undesirable situation because there's nothing left over from what's been put in. No profit means no reward. And, unfortunately, profit is not guaranteed.

whyframestudio/iStock/Thinkstock

That's where taking a risk fits into the picture. Taking a risk involves weighing the possible outcomes and choosing the result most likely to happen. If no one buys your bracelets, your invested time, effort, and money have been wasted because you won't profit or receive a reward. But if your friends tell you that many of your classmates and teachers will buy your bracelets, then you might go for it because the risk is worth the profit you can make.

Examining profit. Let's look at the profit formula more closely:

Income – Expense = Profit

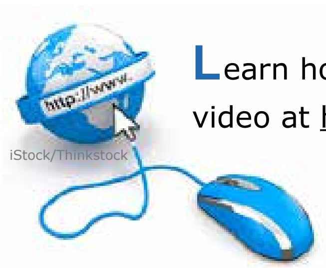
Income is whatever money comes into the business. It is the money received by resource owners and by producers for supplying goods and services to customers. This means that when a business sells a car, a shuttle service, or even some travel advice, the money it receives is its sales income. In the same way, when you sell your bracelets, your income will be the money you receive from your classmates and teachers.

In contrast, the monies that a business spends are its **expenses**. Since you've spent time and effort to complete your bracelets, you might think that time and effort are expenses. You are correct that you've spent them. However, in business, an expense is usually measured in financial terms.

Two kinds of expenses are "cost of goods" and "operating expenses." The **cost of goods** is the amount of money a business pays for the raw materials from which it produces goods to sell. If a business makes hard hats for construction workers, its cost of goods is what it pays for the plastic used to make the hard hats. But the cost of goods is also the amount of money a business pays for the products (or for any part of the products) it sells. You might not think about the soap for a car wash, the design for a new style of boot, or the electric wires and plumbing in a brand-new home. But as part of a product sold, each is a cost of goods.

For you, the cost of goods is what you've paid for the thread, beads, and materials you used to make the bracelets. In fact, it's everything you've purchased to produce your jewelry—from start to finish.

▲ *Constructing a building has many costs that have to be met before a profit is made.*



Learn how to calculate profit by watching the Council for Economic Education's interactive video at http://www.econedlink.org/interactives/EconEdLink-interactive-tool-player.php?iid=219.

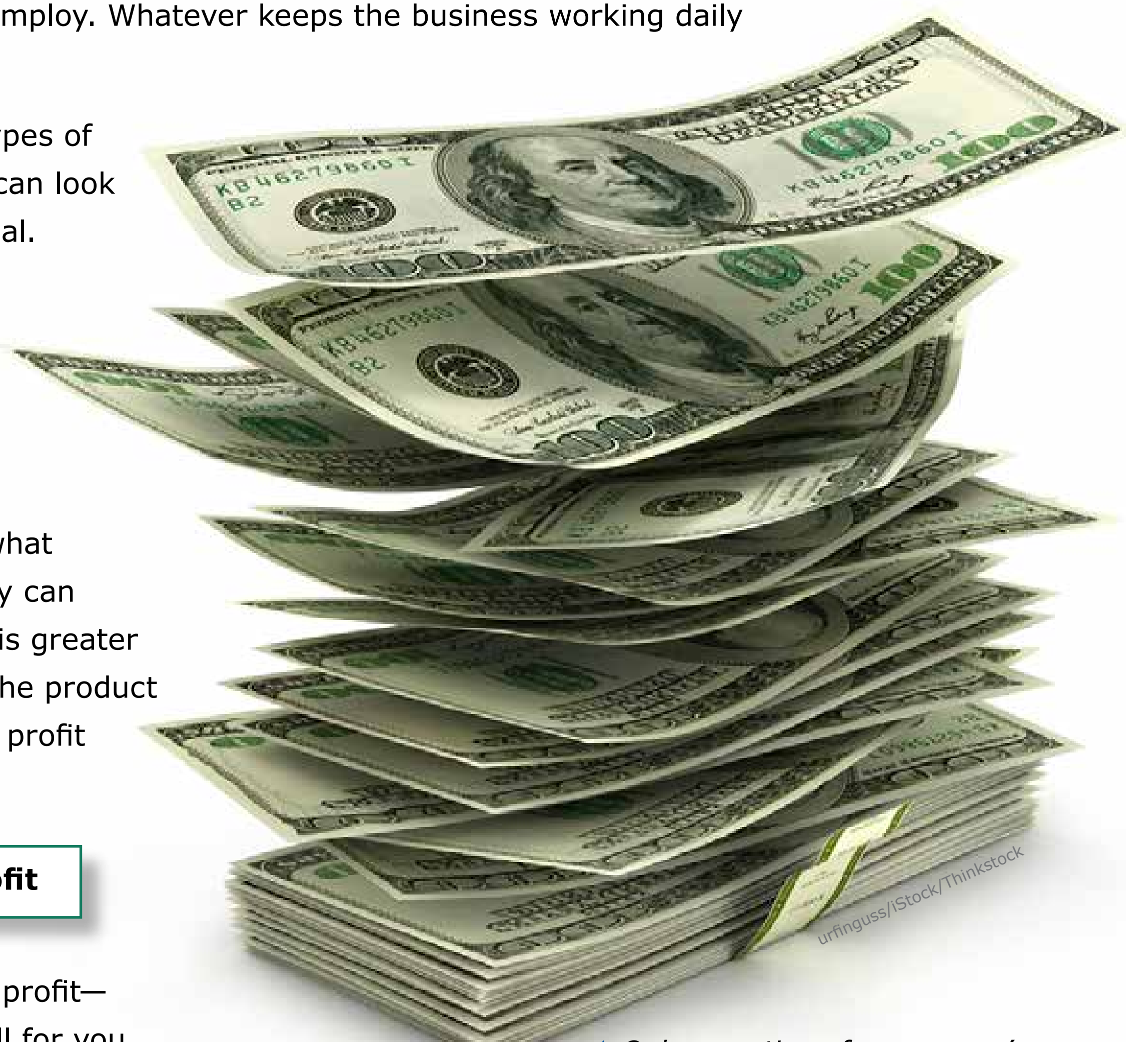
Operating expenses are all of the expenses involved in running a business. You probably didn't notice the electric lighting that helped you see the bracelets you were making. But electricity is something you or someone else paid for so you could produce your jewelry. It's an operating expense—a cost that enables you to do the work. Businesses pay for the buildings they occupy, the utilities they use, and the workers they employ. Whatever keeps the business working daily can be called an operating expense.

Discussing the types of profit. Just as there are two types of expenses, there are two ways to view profit, as well. You can look at the gross profit or the net profit—depending on your goal.

Some business owners are interested in the **gross profit** (money left after the cost-of-goods expense is subtracted from the total income) because they don't want to count the operating expense in the calculation of their reward. Why? Gross profit shows business owners the difference between what they've spent to produce the product and what they've received from selling the product. Right away, they can determine if the money received from selling the product is greater than the money spent. And that helps them determine if the product is worth the expense of production. The formula for gross profit looks like this:

Income from sales – Cost of goods = Gross profit

In your situation, you might choose to calculate the gross profit—especially if your parent or guardian paid the electricity bill for you.



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Only a portion of a company's income is profit.

But a clearer picture of your actual reward comes from calculating the **net profit**—money left after the cost-of-goods expense and operating expenses are subtracted from the total income. Businesses are usually more interested in net profit because they want to know how much extra money they can keep or spend on other things. And, because net profit is a precise calculation of the reward received, it's a realistic way to determine how well a particular business is doing financially. The formula for net profit looks like this:

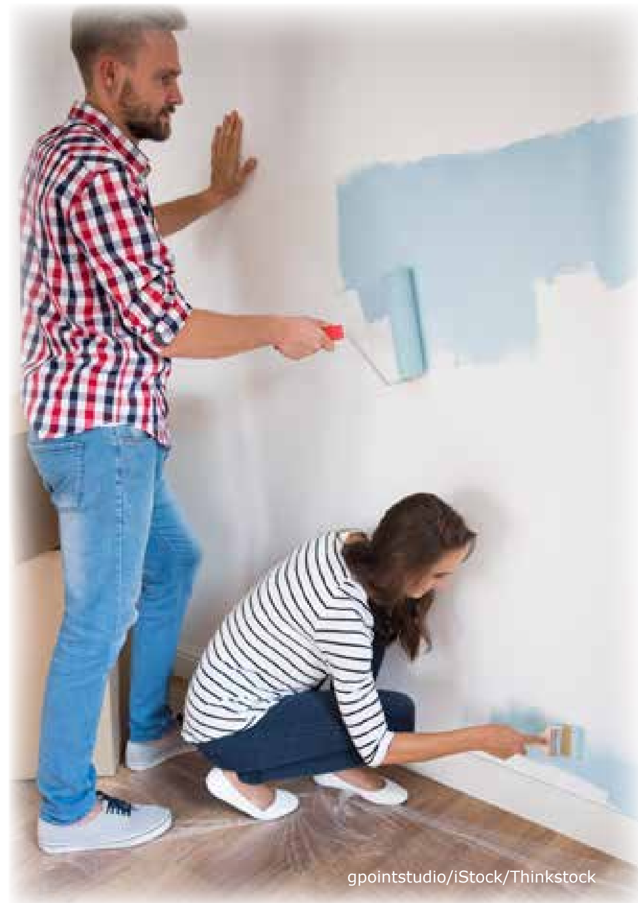
Gross profit – Operating expense = Net profit

In short, the net-profit calculation accurately tells how much is left over after business expenses are accounted for. View the Surrey Accountancy Services video "What's the Difference Between Gross Profit and Net Profit" for a visual explanation: https://www.youtube.com/watch?v=cnA0INKCu00.

Revealing the profit motive. Not surprisingly, it's what's left over that drives business owners to do what they do—from the very first day of running the business. Just as you want a reward for your work, business owners want a reward for their efforts, too. And, the greater the reward, the more owners can do with it. Consider opportunities, such as:

- Building a new facility
- Expanding into a new location
- Producing an additional product
- Giving to charity
- Sponsoring research

What businesses can do depends on how much businesses receive for their efforts. If this is the case, then how much profit is enough? As you might expect, each business owner answers that question in his/her own way.



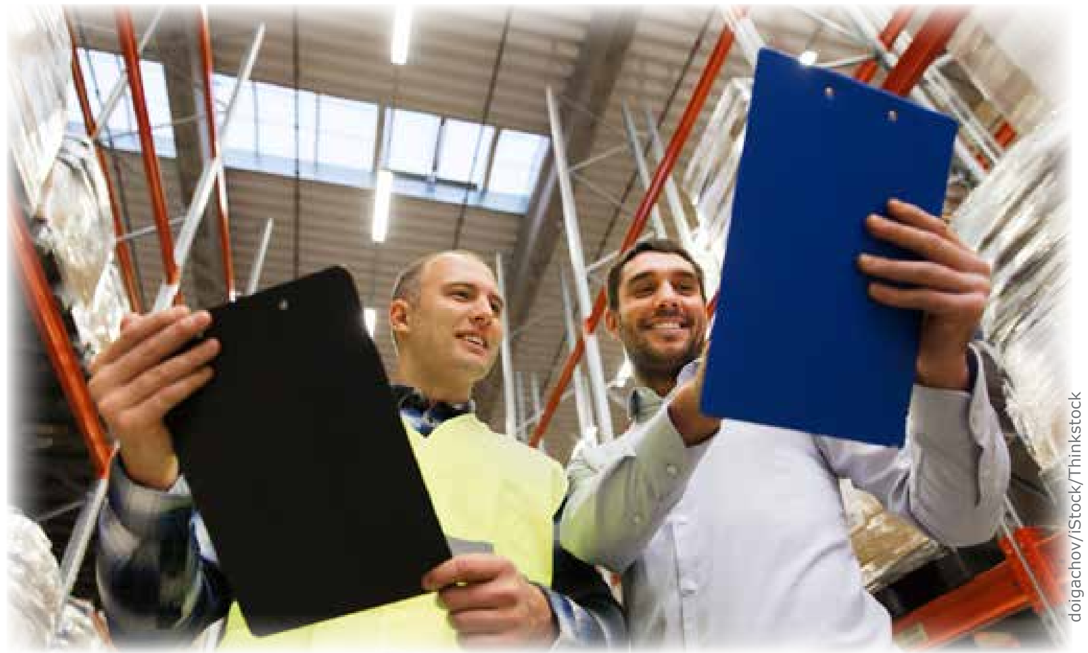
▲ *A profitable business can donate materials, fixtures or labor to construct housing for those in need.*

Why Profit Is Important

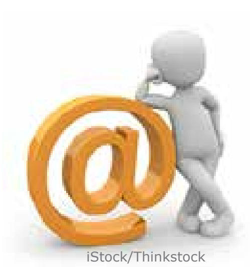
Profits are important and beneficial to businesses as well as society. The **profit motive**—the desire to earn a profit—is what keeps our **private enterprise system** operating every day.

Benefits for business owners. The possibility of making a profit certainly motivates business owners to take the risks they do. But profit can also provide business owners with the satisfaction that comes from owning their own businesses and from serving the people in their communities.

You've probably received some satisfaction from designing and making your bracelets. And, when you sell your bracelets, you'll get the opportunity to share your love of jewelry with your classmates—producing even more inner satisfaction. So, just as the financial side of making a profit is helpful, the non-financial side is beneficial, too.



▲ *Profitable business owners enjoy the reward of success.*



Learn more about the non-financial benefits that one young entrepreneur, Hart Main, gets from his business success in the video "Biz Kid$ Episode 506—Man Cans Profile": https://www.youtube.com/watch?v=8euVDKIAs2E.

Benefits in general. But business owners aren't the only ones who benefit from profit. The entire trading environment is affected by whether or not businesses perform well financially, because with "enough left over," businesses can:

- Meet consumers' needs and wants
- Provide better wages and employment opportunities
- Strengthen the economy

You might understand how businesses can meet consumers' needs and wants by providing them with goods and services. But how does profit benefit employees and the **economy**?

Profit makes affording employees possible. It allows businesses to:

- Hire and promote employees
- Pay salaries and wages
- Offer benefits

If a bagel shop needs extra help, for example, it can afford to hire workers with what's left after paying expenses. And if a large bread-making business receives enough profit, it can add an entirely new division—and hire the employees required to run it. So with profit, businesses can provide employment opportunities, on a small or large scale. And with more profit, businesses can hire more employees and provide better pay and benefits.

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For an extraordinary example of a business owner sharing his business's profits with employees, view the *NBC News video* "Chobani CEO Giving Employees an Ownership Stake in Yogurt Empire": https://www.youtube.com/watch?v=HyHVLq-KtFo.

In the process, profit makes economic trade stronger. As businesses grow, expand, and hire more employees, they develop new or improved products that customers purchase. You might have purchased an iPad, for example, or picked up the latest tooth-whitening kit for yourself. Each purchase opportunity strengthens the economy by encouraging the trade which yields more profit.

In addition, businesses regularly compete with other businesses so they can meet the needs of customers before their rivals do. With this incentive, businesses focus their efforts—and invest their time and money—to achieve profit as soon as possible.

Rawpixel/iStock/Thinkstock

▲ Society benefits from public libraries that are funded by taxes.

As businesses grow, they pay **taxes** to the government. With tax money from profitable firms, the government can pay for essential services programs, which benefit all citizens. You wouldn't want to live without highways, national defense, or public education, would you?

While a profitable firm must pay taxes, it often chooses to contribute to charitable causes on its own. By investing in the community, businesses can make a considerable difference—by addressing issues (such as poverty and disease) and by promoting worthy causes (such as education). If you've ever participated in a business-sponsored event (such as a "walk-a-thon") to raise money for medical research, you know the value of a firm's assistance in the community. Many businesses regularly support charitable causes, and some even tie their profit motive directly to giving.

Video

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The *Forbes* video "Toms: The Business of Footwear and Philanthropy" explains how a charitable business model can lead to greater profit: http://www.forbes.com/video/4194983247001/.

Whether it's through purchase opportunities, competitive situations, tax payments, or community assistance, profit makes an impact in the day-to-day functioning of our economy. And overall, as businesses produce the profit that yields more profit, they are involved in both the cause and effect of a stronger economy.

No benefits at all. Without profit, a business can last only a short while. In tough times, the business can draw money from savings or use credit to get by. But if no profit is generated for an extended period, the business must shut down because it has no way to pay its employees, **suppliers**, or **creditors**. It's easy to see that profit plays a significant role in the firm's ability to do business.

Summary

Profit is the reward for taking the risk of investing in a business. It's what's left over after expenses have been subtracted from sales income. Two types of profit are gross profit and net profit. Making a profit provides both motivation and satisfaction for businesses. In general, profit meets consumers' needs, provides employment opportunities, and strengthens the economy. Without profit, businesses could not last very long.

TOTAL RECALL

1. What is profit?
2. How is profit calculated?
3. How is risk involved in calculating profit?
4. Describe the difference between income and expenses.
5. Describe the difference between cost of goods and operating expenses.
6. Describe the difference between gross profit and net profit.
7. Name two benefits profit provides business owners.
8. Name three benefits profit provides businesses in general.

The Gray Zone

Jared, a graphic arts student, has agreed to design a logo to capture the essence of his friends' new club. Club members are looking forward to ordering T-shirts so they can sport the new logo and promote their club.

Jared asks the club members if $15 an hour is an acceptable design fee for an estimated five hours' worth of work. They agree to Jared's terms—expecting to spend $75 total.

It will only cost Jared about $5 an hour for using the computer software and utilities, he thinks. So, he'll receive a profit of $10 for each hour he works. If he works five hours, he'll receive $50 in profit. Not bad!

When Jared wakes up the next morning, however, he feels too sleepy to work very fast. The project takes him seven hours instead of five. Seven hours of work at $15 an hour is $105—much more than his friends are expecting to pay. His total profit at $10 per hour comes to $70, instead of $50.

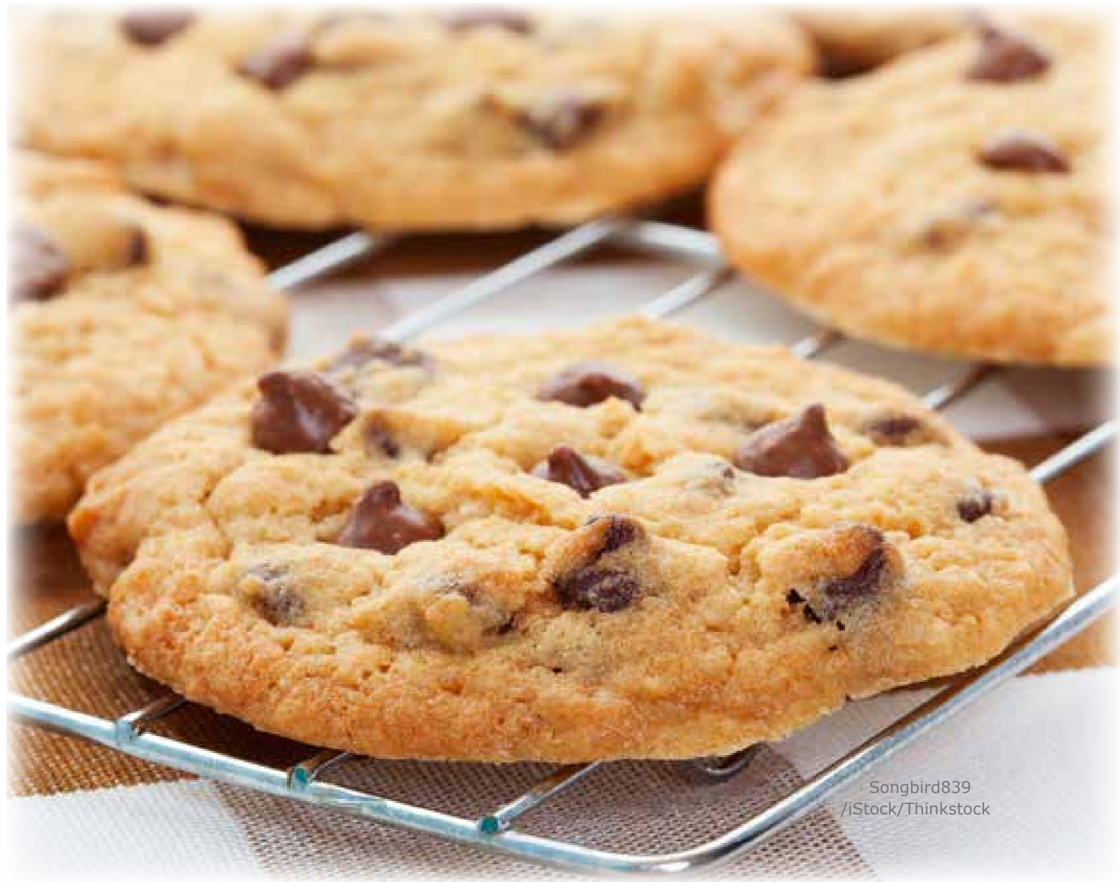
Does Jared have the right to charge for the full seven hours? What do you think Jared should do?

More Than Enough

When your friend, Cory, tells you that he plans to bring a batch of his homemade chocolate chip cookies to school to sell tomorrow, you immediately ask him to save some of them for you.

You're positive that Cory's sweet, gooey cookies will be a huge hit. Since he's only making three dozen to sell, you expect the cookies to disappear fast. You tell Cory that he is going to make a lot of "dough."

But Cory doesn't feel as confident. He hasn't taken the time to consider how much profit he'll make—or what might influence the amount of profit he'll receive.



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▲ Determining actual profit isn't as simple as counting items available to sell.

What Affects Profit

The factors that affect how much profit Cory will receive are the same factors that affect the profit of any business. But some factors are not within Cory's control.

External impact. Cory cannot control certain outside influences: how much spending money the students will have, the number and type of cookies they will want to buy, or any surprises that might prevent sales. These are external factors, known as:

- The economy
- Demand
- Chance

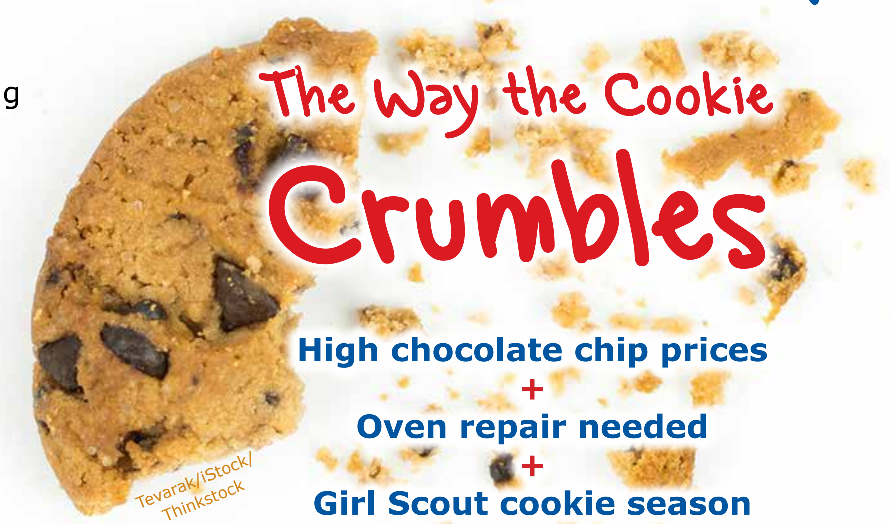
The economy. When the economy is good, people are working and earning enough money to buy things. In a good economy, Cory may encounter many buyers—ready to spend money on his homemade cookies.

But in a bad economy, people are out of work and can't afford extra purchases. Even if Cory diligently prepares to sell his cookies to the students during this time, the students may not necessarily be able to afford them. And if the students can't afford to buy his cookies, Cory won't make a profit.

Is there anything Cory can do to prevent a bad economy—or create a good one? No. By himself, Cory cannot control whether or not people are working so they'll have money in their pockets. Cory can simply hope for a good economy. He can hope that the amount of money customers have to spend increases, making more profit available for business owners.

Demand. Whether or not the economy is good, a product may become all the rage if the trend is to buy it. On the other hand, the product may become less popular if something else becomes the thing to have instead. For example, if the school holds a cookie dough fundraiser, students may choose to make their own cookies instead of buying Cory's. Because demand and profit go hand in hand, when demand changes, profit changes, too. This means that when people buy more cookies, Cory makes more profit. And when they buy fewer cookies, he makes less profit.

Chance. Another outside influence is chance. What if Cory's oven breaks down? Or what if a fire destroys his kitchen or home? Cory can't control surprise events that might prevent cookie sales. But not all unexpected events are negative. Some surprises actually help. If chocolate chips go on sale, Cory's expenses will be less, and he can make more profit.



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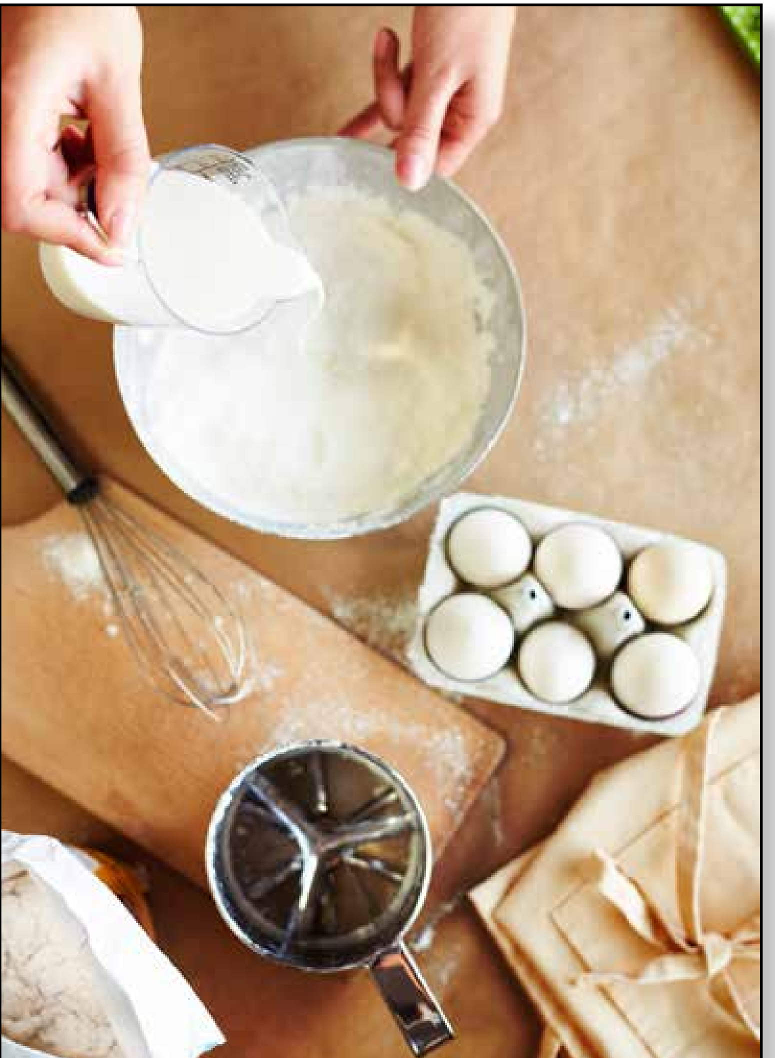
The Way the Cookie Crumbles

High chocolate chip prices
+
Oven repair needed
+
Girl Scout cookie season
+
Best customer on a diet

Unexpected problems can eat up profits.

Internal impact. Some things are within Cory's control. For example, he can usually control how much he spends to make the cookies and how much he charges for each cookie. These are internal factors known as expenses and pricing.



▲ *The wise use of supplies helps a business control expenses.*

Expenses. When Cory wants to make a batch of cookies, he has to buy the ingredients; purchase cookie sheets, mixing bowls, and cooking utensils; buy (or rent) an oven; pay for the electricity to run the oven; and pay for the dish soap to clean up afterwards. Whatever Cory spends to make a batch of cookies is an expense. If Cory spends less to make Batch A and more to make Batch B, which batch is likely to bring him higher profits if both are priced the same? You guessed it: Batch A. Expenses affect profits like this: When expenses go up, profits go down, and when expenses go down, profits go up. If Cory is careful to spend as little as possible, his profits are likely to show it.

Pricing. In addition, when Cory raises the price of each cookie, he can expect a higher profit for each sale. But raising prices is a little more involved than just putting a new sticker on a package. If someone else decides to sell homemade cookies for less than Cory, he might lose customers and not receive the profit he was expecting. So even though Cory might increase his profit by raising prices, he would be smart to investigate what customers are willing to pay, too.

Video

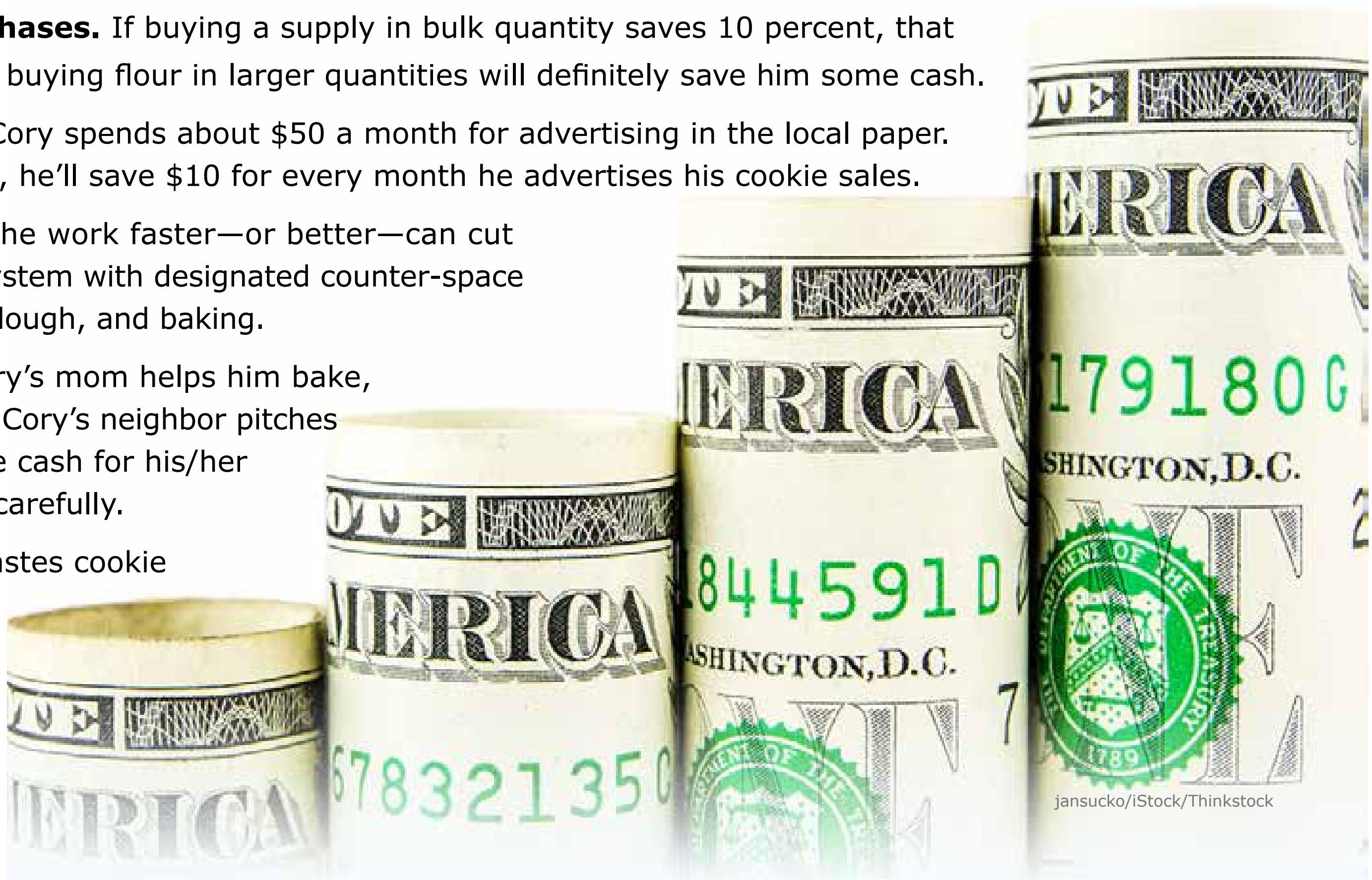
The video "Supply & Dance, Man!"
shows the impact demand and supply have on price:
https://wetheeconomy.com/films/supply-and-dance-man/.

How to Increase Profit

In light of the things Cory can control, how can he increase his profit? Though profit isn't fixed or guaranteed, Cory can increase his profit by decreasing his expenses and increasing his sales. Let's look at some ways he (or any other business) can do that.

To decrease expenses:

- **Eliminate some free services.** When firms offer free delivery or free gift-wrapping, they are spending money that could go toward profit. Cory doesn't offer anything "free" right now, so he can't save money by eliminating a service.
- **Get the best rates on supplier purchases.** If buying a supply in bulk quantity saves 10 percent, that savings can go toward profit. For Cory, buying flour in larger quantities will definitely save him some cash.
- **Get the best rates on advertising.** Cory spends about $50 a month for advertising in the local paper. If he works out a deal for $40 a month, he'll save $10 for every month he advertises his cookie sales.
- **Increase worker efficiency.** Doing the work faster—or better—can cut expensive corners. Cory can set up a system with designated counter-space in his kitchen for mixing, dropping the dough, and baking.
- **Avoid extra payroll expenses.** If Cory's mom helps him bake, Cory won't have to pay his mom. But if Cory's neighbor pitches in, Cory will need to give him/her some cash for his/her time. So, Cory should pick his helpers carefully.
- **Use resources wisely.** Splattering wastes cookie dough, of course. And so does eating it before it's cooked! Whatever Cory consumes or wastes in the process is a cookie (or part of a cookie) he can't sell—or profit from.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To increase sales:

- **Change what you provide.** Cory could expand his business by baking and selling peanut butter cookies or shortbread cookies, too. For each new type of cookie he offers, Cory can attract new or additional buyers. He could even decide to sell packages of his cookie dough and eliminate baking expenses to realize more profit.
- **Beat the competition.** If Cory's rival sells 30 cookies in a package, Cory could sell 45. If the rival sells individual cookies for $1.50 each, Cory could sell his for $1.30. And if the rival chooses to include another ingredient such as almonds in the chocolate chip cookies, Cory could include cashews. Whatever makes Cory's product more desirable than his rival's is likely to bring Cory some profit.

Summary

To understand how to increase profit, you need to examine both the external and internal factors that influence it. While external factors include the economy, demand, and chance, internal factors include expenses and pricing. Whether external or internal, these influences are not all beyond a business owner's control. By decreasing expenses and increasing sales, an owner can increase the chances of receiving increased profit—and increased satisfaction, as well.

TOTAL RECALL

1. How does the economy affect a firm's profit?
2. How does demand affect a firm's profit?
3. How does chance affect a firm's profit?
4. How do expenses affect a firm's profit?
5. How does pricing affect a firm's profit?
6. What are two ways to increase profit?

Make It Pay!

Regardless of a business's profit, there is usually some way to make that profit grow. What could your employer do to decrease expenses or increase sales? If you're not currently employed, think about a school-based enterprise or school fundraiser you are familiar with. What actions could your school group take to increase its profits?

