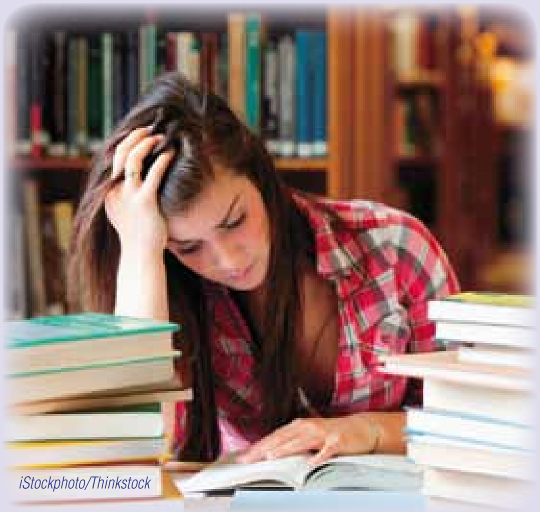
How Much Is Enough?

Objective A

So What?



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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 that 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 a profit—whether you realized it or not.

Objectives

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

B. Describe factors affecting profit.

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Imagine you want to sell some friendship bracelets you've made. Since your friends have told you that you have a "knack" for jewelry making, you hope your classmates will snatch up lots of bracelets—right away. To prepare for the sale, you've spent long hours doing what it takes to complete your project successfully—selecting or developing bracelet designs, purchasing supplies, and weaving the bracelets. In all, you've made 50 friendship bracelets of varying sizes, colors, and materials. And, now, you're ready to start selling your jewelry.

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▲ The key to earning a profit—regardless of what good or service you sell—is earning more income than you spend on expenses.

But what do you expect to get in return for your efforts? And, how can you tell if what you receive is enough?

What Profit Is

If you're like most people, you want to get something for what you spend. You don't want to put a lot into 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 out of 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.

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. So, if no one buys your bracelets, you'll know that your invested time, effort, and money have been wasted because you won't get a reward. But if your friends tell you that many of your classmates will buy your bracelets, then you might go for it—because you decide the risk is worth it.

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

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Income – Expense = Profit

Income is whatever money comes into the business—usually from sales. 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 friendship bracelets, your income will be the money you receive from your classmates.

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—but 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—the actual material used in the hard hat. 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 any other materials you used in the bracelets. In fact, it's everything you've purchased to produce your jewelry—from start to finish.

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 friendship bracelets you were making. But electricity is something you or someone else paid for so that 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.

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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

Objective A

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

But a clearer picture of your actual reward comes from calculating the **net profit**—money left after the cost-of-goods expense and the operating expense are each 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 all is said and done.

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.

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 provides the motivation—the reason—for 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 friendship bracelets. And, when you sell your bracelets, you'll get the opportunity to share your love of jewelry (and friendship!) 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.

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


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▲ Profit does more than provide business owners with financial rewards. It also gives them the satisfaction that comes from owning their own businesses and from serving their communities.

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.

In the process, profit makes economic trade stronger. As businesses grow, expand, and hire more employees, they develop new or improved products—which customers purchase. You might have purchased an Apple iPod, 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.

The Gray Zone

Jared, a graphic arts buff, has agreed to do a graphic design for his friends' new club. He's creating a logo to capture the essence of what the club is all about—so the club members can buy matching shirts sporting the new logo.

Jared asks the club members if $15 an hour is an acceptable 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?

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.

So, 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 in the long run, the business must shut down—because it has no way to pay its employees, suppliers, or creditors. So, as the reward for a firm's efforts, profit plays a significant role in the firm's ability to do business.

▲ Without profit, businesses can't survive for long.

Objective A

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.

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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.

Objective B

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▲ Outside influences (i.e., the economy, demand, and chance) and internal factors (i.e., expenses and pricing) impact even very small businesses' profits.

More Than Enough

When you hear that your classmate, Cory, wants to begin selling his homemade chocolate-chip cookies, you immediately ask him to save a few cookies for you. You're guessing that crowds of high-school students will want to buy Cory's cookies. And you know that, right now, he has only three dozen. So, you expect the cookies to go fast—and you mention to Cory that he should make more than enough profit.

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.

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. So, 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.

▲ When demand is high, businesses usually make more profit. But, when demand declines, businesses' profits decline as well.

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," instead. Because demand and profit go hand in hand, when demand changes, profit changes, too. This means that, when more people buy cookies (or more of them), Cory makes more profit. And, when Cory doesn't sell as many cookies, he makes less profit.

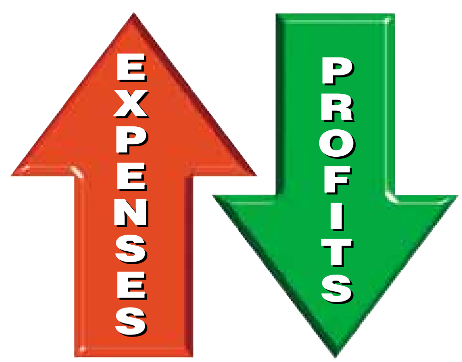
Chance. Another outside influence is chance. What if Cory's oven breaks down? Or, what if a tornado wipes out the local flour mill? Cory can't control surprise events that might prevent cookie sales. But, not all unexpected events are negative. Some surprises actually help. If chocolate chips go on sale, Cory doesn't have to spend as much on ingredients and can keep more of that cash in his pocket.

Internal impact. Some things are within Cory's control, however—at least somewhat. Cory 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.

Expenses. When Cory wants to make a batch of cookies, he has to buy the ingredients, 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. So, 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 decides to raise 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 does, he might lose customers and not receive the profit he was expecting. So, even though Cory can raise his own profit by raising prices, he would be smart to investigate what customers are willing to pay, too.

When expenses go up, profits go down.



When expenses go down, profits go up.

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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.

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.

Objective 3

- **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.

How to Increase Profit

Decrease expenses:

- Eliminate some free services.
- Get the best rates on supplier purchases.
- Get the best rates on advertising.
- Increase worker efficiency.
- Avoid extra payroll expenses.
- Use resources wisely.

Increase sales:

- Change what you provide.
- Beat the competition.

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 with which you are familiar. What could your school group do to increase its profits?

- **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 get profit for.

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.
- **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?