Profit

Meaning & importance of profit

Profit is a very important concept for any business – particularly a start-up

Profit is the financial **return** or **reward** that entrepreneurs aim to achieve to reflect the **risk** that they take.

Given that most entrepreneurs **invest** in order to make a return, the profit earned by a business can be used to measure the success of that investment.

Profit is also an important signal to other providers of finance to a business. Banks, suppliers and other lenders are more likely to provide finance to a business that can demonstrate that it makes a profit (or is very likely to do so in the near future) and that it can pay debts as they fall due.

Profit is also an important **source of finance** for a business. Profits earned which are kept in the business (i.e. not distributed to the owners via dividends or other payments) are known as **retained profits**.

Retained profits are an important source of finance for any business, but especially start-up or small businesses. The moment a product is sold for more than it cost to produce, then a profit is earned which can be reinvested.

Profit can be measured and calculated. So here is the formula:

PROFIT = TOTAL SALES less TOTAL COSTS

Here is an example which illustrates the formula in action:

Sales	Costs	Profit or Loss?
£100,000	£75,000	£25,000 (profit)
£100,000	£125,000	£25,000 (loss)
Total sales greater than total costs Total costs greater than total sales Total sales = total costs		= Profit = Loss = Break-even

How profit is used

Profit arises when total sales exceed total cost for a period.

Once a profit has been made, the owners of the business have a choice:

(1) Take the profit out of the business (e.g. pay a dividend to shareholders)
(2) **Retain** the profit in the business – either in cash or by investing the profit into new assets

Most entrepreneurs reinvested or "retain" profits in a business. Why?

Profit is the most important source of finance for a business. It is defined as being an "internal source" in the sense that it is generated from within the business.

Why is profit important as a source of finance? Because it is entirely within the control of the business – it is not provided by outsiders.

Another reason is that retained profits are relatively cheap. They do have a cost – which is the return that the business owners could obtain by taking the money out of the business. However, the true cost of retained profit is much less than paying interest on a bank loan or overdraft.

What can profit be reinvested in? Essentially to help the business grow: e.g.

- Additional production capacity
- Investment in information technology
- To buy more stocks of raw materials and components

The alternative use for profit is to pay it as a reward or return to the business owners. For shareholders in a company, this method is known as a dividend.

A dividend provides a shareholder with one part of his/her return on investment.

The second part of the return comes when the value of the shares in the company increases.

Handling a loss

A **loss** arises when **total costs are more than total revenues in a period.**

Over time, losses generally result in a **cash outflow** from a business. If the business does not have sufficient sources of finance to fund these losses, then it will not survive.

It is important to remember that losses are fairly common in business – particularly for start-ups or for businesses that are investing in a new product or market.

It is often the case that a business has to incur substantial costs (e.g. research, design, promotion) before it is able to generate revenues for a new business or product.

However, sustained or substantial losses place a business in trouble. A high proportion of start-ups go out of business because they fail to reach profitability. In other words, they do not manage to reach the **break-even** output.

Why might a business experience a loss when the business plan or budget expected a profit? The main reasons are:

- Revenues are lower than expected (the most likely) – entrepreneurs tend to be over-optimistic with their forecasts for revenues
- The business proves to be less productive or efficient than planned – e.g. it suffers from a higher degree of wastage during production, or suffers from too much capacity
- Unexpected costs arise – ether costs that were not planned at all (e.g. a customer or supplier dispute) or where costs turn out to be much higher than expected
- The business suffers from unexpected changes outside its control – e.g. a rise in bank interest rates, a sudden change in consumer confidence, poor weather

The response to a loss should include:

- Reviewing the profit and cash flow forecasts to ensure that the business has sufficient cash to remain viable
- Looking at all major cost categories to see where savings can be made which do not damage revenues
- Renewed marketing activities to boost revenues – particularly in the short-term if cash flow is a problem