Importance of profit in business

ASSIGN BUSTER

Profit acts as a vital role in the functioning of the economic system. In any industry profit acts as a signal that buyers want more output from that industry. Profits provide incentive for firms to increase production and encourage new firms to enter into that industry. The profit cannot be seen as a selfish motive of any business but induces entrepreneurs to take long business risk. Unless there are no prospects of generating profit entrepreneurs will not devote time and invest resources in any business activity. It encourages firms to develop new products to lower production cost and to provide better services to the consumers. Profit is also expands business activity of the organization. Profit generated from the business reinvests again to expand production or invest into new business. So it allows the firm to continue to business operation. Entrepreneurs can only be motivated to expand its business when it can successfully generate profits from its business operations.

The objectives of business objectives besides profit are facilitative objectives and are meant to be subservient to the profit motive. It can be pointed out that private enterprises are operated on behalf of and for the benefit of the owners. It can be advocated that the owners who have assumed the business risk of investing their funds should get suitable return in terms of profit. It is a reward for the entrepreneurs to share the owning and operating business and also serves as a stimulant for business effort. In any business organization profit is treated as a financial yardstick for measuring business efficiency and for evaluating managerial competency. It evaluates how well the decisions and actions of managements turn out to be effective and how well unwise resources to maximize value for the organization. Profit is the

main indication how competitive be business organization is. Business efficiency is often expressed as price- Earning, profit to sales volume, earning to capital employed, earning per share and so on. It is directly or indirectly released to profit generated by the business organization. Outside investors also equate profit with the degree of business efficiency and managerial competence and commit their funds in light of such equation and other related assessments.

So the manger uses its resources and engages in activities designed to increase its profits so long as it stays within the rules of the game. The directors of companies have a fiduciary responsibility to act in the best interest of the shareholders. The managers are agents of the shareholders and therefore have a moral obligation to manage the firm in the interest of the shareholders, which obviously is to make as much money as possible and maximize shareholder wealth. The shareholders are the owners of the organization and therefore the profits belong to them.

The firm's objective is also to finance company's growth, create value not only for its shareholders and also create wealth for all the stake holders for the society. Profit provides resources required to achieve the corporate objectives. As business is a continuing entity it must grow and expand for its sustainability and profit allows the firm to reinvest in new and emerging business opportunities. Profit is highly correlated to generating cash, which brings more flexibility to the business at a lower cost. Stockholders (owners) have a financial interest in the business and obviously expect financial return. The business affects their livelihood because they need money to live and purchase material things.

In a market characterized by many firms competing with one another, above normal profits provide important signals, but are not likely to be maintained over long periods of time. That is firms already in the market respond to higher profits by increasing output and new firms will have an incentive to enter the market as well. The result will be on an increased supply of the product, lower prices and ultimately lower profits. The result in competitive markets is that profits provide important signals but are somewhat transitory in nature.

It can also be argued that a manger of a business organization has a direct responsibility to his/her employers to conduct business in accordance with their desire usually to make as much money as possible.

Elasticity

An important concept in understanding supply and demand theory is elasticty and it has a profuound impact on the profit of an organisation. In this context, it refers to how supply and demand change in response to various stimuli.

The elasticity of demand measures the responsiveness of demand to changes in a factor that affects demand. Elasticities can be estimated for price, income, prices of related products, and advertising expenditures. The own-price elasticity is the ratio of the percentage change in quantity demanded to the percentage change in price, and is a negative number. Demand is price elastic if a 1% increase in price leads to more than a 1% drop in quantity demanded, and inelastic if it leads to less than a 1% drop in quantity demanded.

Price Elasticity of Demand

A Price change can either increase or decrease total revenue, depending upon the nature of the demand function. The profit of the firm depends upon the sales revenue of the firm and sales revenue is subject marked demand and price of the product. Here Price Elasticity of demand plays a crucial role and determines the level of real demand of the product. Price Elasticity of demand mans responsive of the consumer towards product when there is a change in the price of the product.

Price Elastic of Demand = % Change in demand / % Change in Price.

The firm needs to consider aspects of their pricing whether they want to aim for a large market share with a low price. In this case they would want to consider market penetration as a pricing strategy. This would mean setting a low price (and correspondingly lower profit margin on each unit), but selling a higher volume. This depends considerably on whether the product is elastic in demand. If the product of the firm is highly elastic, any increase of the product will affects its sales in the market. For example when a firm decides to increase the price of any product which is highly elastic, the consumer’s demand for the product will decline in the market and in result affects the sales of the product in the market and consequently to the hampers the profit of the firm. If the product is highly inelastic the consumer usually doesn’t respond to any increase or increase in the price of the product in the market. So if the firm increases the price of an inelastic product, it does not affect the sales of the product significantly but on other hand it increases the sales revenue of that product. It should be kept in mind that high sales

revenue does not necessarily mean high profit. The firm has to decide at what price the firm will attain maximize profit (when marginal revenue = marginal cost).

Income Elasticity of Demand

The income elasticity for a firm's product is a crucial force of the farm's success (profit) at different stages of business cycle. During the period of economic boom incomes are raising and demands for various products including the firms product increases in the market. As a result revenue of the firm increases and consequently firm generates profit from the product. During period of economic recession, it affects the sales performances of almost all industries across the broad as incomes of the consumptions decrease. The firm's product does not find demand in the market. It leads to price reduction and lower sales revenue of the firm. Firms also have to incur various costs on marketing and advertising to woo customers. As a result profit of the firm suffered.

Income Elasticity can be either positive or negative when income elasticity in negative, an increase in income is associated with a decrease in the quantity demanded of the good or service. Firms producing cheap goods, its profit is adversely affected when incomes of its targeted customers increase. The consumers switch over to better goods when their income increases and consequently sales of the firm affected adversely and so the profit. Similarly income elasticity is positive but less than or equal to the percentage change in income. Such goods and services referred to, as necessities demand for those goods is not longer affected by change in income. The sales of

essential goods is generally unaffected by change in income of consumers and its profit depend on its pricing policy. But it must be remembered that government regulates directly or indirectly prices of essential goods in the market. In case of luxury goods the change in demand is proportionately greater than the change in income. As individuals become richer, they have more income to spend or luxurious products and services. The sales of luxurious goods increases, as incomes of the consumers increase in the economy and it favorable affects the profitability of the firm.

Labour Productivity and Profit

Improving productivity is the most direct way to increase productivity. In business particularly in manufacturing industry wages of labour is a large share of cost production. Improved labour productivity curtails costs of manufacturing come primarily from. Improved productivity reflects two types of activity changes: Fewer people doing the same amount of work (due to automation and capital substitution), and reducing the number of employees necessary to reach a given level of sales (due to increases in labor productivity). In other words, greater labor productivity reduces the costs of operation for a given level of production, distribution, sales, makes it feasible to make higher profits from the business. Rapid productivity growth allows businesses to pad profits or boost pay without facing a need to raise prices for their products or services. As productivity slows, profit margins could erode unless businesses pass along their increased production costs to consumers. Profit sharing is a form of labor compensation in which the employees get higher wages when company profits are higher. The idea is that profit sharing increases the incentive to work harder and “ work

smarter," and thus increases profits. On the whole, the studies confirm this, showing that there is at least some scope for increasing profits through the productivity effect.

Now let us assume that the firm introduces a new system of working that leads to a rise in output per worker from 2000 to 2500 per year. It may not necessarily imply that the workers are working harder; it could be that they are working ' smarter'. Cell production for example, is one way in which waste can be reduced in terms of time spent moving units from one part of a factory to another and from one worker to another. It could be that the firm has invested in machinery that is more efficient or has reorganized the production line in some way. Of course, the workers might want extra money in return for these changing working practices so let us assume that they have been offered a pay rise of 5% taking their annual salary to $15, 750 per year.

The total cost of labour is now 50 x $15, 750 = £787, 500. Output however has risen from 100, 000 to 125, 000. The cost per unit therefore is now $6. 30. Even if the firm continues to sell its product at the same price as before it has increased its profit margin.

The purpose of the business is to maximize profits. But that's not the purpose for other stakeholders—for customers, employees, suppliers, and the community. Each of those groups will define the purpose of the business in terms of its own needs and desires, and each perspective is valid and legitimate. It is also simply good business for a company to cater to its customers, train and retain its employees, build long-term positive

relationships with its suppliers, and become a good citizen in its community, including performing some philanthropic activity. The business organization should deal with all its various constituencies properly in order to maximize long-term shareholder value.

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