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Contents

Chapter 24 Break-even (1): revenue, costs and profit

Linked to: 25: Break-even (2): analysis; 26: Profit and profitability.

Concept

Revenue is the value of total sales made by a business within a period, usually one year. Costs are the expenses incurred by a firm in producing and selling its products, such as wages and raw materials. Profit is made when a firm's sales revenue exceeds its total costs.

24.1 The measurement and importance of profit

Profit is measured by deducting all business costs from the revenues generated within a trading period – say six months. Business people sometimes say that 'revenue is vanity; profit is sanity'. In other words, making lots of sales feels great, but there is no business purpose in selling things unless profits are generated. Full details on measuring profit are covered in Chapter 27.

Profits are important for the following reasons:

- They provide a measure of the success of the organisation.
- Profits are the best source of capital for investment in the growth of the business, for example, to finance new store openings or to pay for new product development.
- They act as a magnet to attract further funds from investors enticed by the possibility of high returns on their investment.

'One of our most important management tasks is maintaining the proper balance between short-term profit performance and investment for future strength and growth.'
David Packard, computer pioneer

However, it is not uncommon for a new business to fail to make profits in the first months – or even years – of trading. The need to generate profits becomes more important as time passes. A business ultimately needs to make profits to reward its owners for putting money into the enterprise.

Perhaps oddly, profit is also important to social enterprises and charities. In 2022 the combination of the Covid-19 pandemic and a cost of living crisis meant charitable giving in the UK fell by nearly a half. Charities with important long-term programmes such as Oxfam needed to dip into their reserves to tide themselves over during the drop in income. Accumulated profits insulate organisations from erratic factors, keeping them on track to achieve their goals.

To understand profit, it is first necessary to look at revenues and costs.

24.2 Revenue

The revenue received by a firm as a result of trading activities is a critical factor in its success. Entrepreneurs start their financial planning by assessing the revenue that they are likely to receive during the coming financial year. This can be calculated using this formula:

$$\text{Sales revenue} = \text{volume of goods sold} \times \text{average selling price}$$

A firm seeking to increase its revenue can plan to sell more or aim to sell at a higher price. Some firms may maintain high prices even though this policy depresses sales. Such companies, perhaps selling fashion or high-technology products, believe that in the long run this approach will lead to higher revenue and higher profits.

The term revenue is also sometimes referred to as 'turnover' or 'sales'.

Real business

Boohoo Group Plc's falling revenue

In the 12 months ending 29 February 2024 Boohoo Group Plc saw its revenue drop from £1,760 million to £1,460 million. The reason for the 17 per cent fall in revenue was ferocious competition from Shein and Temu. In trying to hold prices high enough to keep making a profit, Boohoo lost sales to its Chinese competitors. The result of the revenue decline was to plunge the business deep into loss-making, with a £160 million loss recorded for 2024.

The other way to boost revenue is to charge a low price in an attempt to sell as many products as possible. In some markets this may lead to high revenues and profits. Firms following this approach are likely to be operating in markets in which the goods are fairly similar and consumers do not exhibit strong preferences for any brand. This is true of the market for young holidaymakers going to Turkey or Thailand. Price competition is fierce as businesses seek to maximise their revenue.

Traditionally, companies printed price lists that might run for 12 months. Today, online purchasing makes **dynamic pricing** more common; that is, allowing prices to rise and fall depending on demand and supply conditions. This is a way to maximise revenue, by charging high prices when demand is at its highest, but much more modest prices during periods of low demand. Football teams such as West Ham United FC do something similar, offering 'Kids for a Quid' when their home game is against an unfashionable opponent.

24.3 The costs of production

Costs are a critical element of the information necessary to manage a business successfully. Managers need to be aware of the costs of all aspects of their business for a number of reasons.

- They need to know the cost of production to assess whether it is profitable to supply the market at the current price.
- They need to know actual costs to allow comparisons with their forecasted (or budgeted) figures. This will allow them to make judgements concerning the cost-efficiency of different parts of the business.

Fixed and variable costs is an important classification of the costs encountered by businesses. This classification has a number of uses. For example, it is the basis for calculating break-even, which is covered in Chapter 25.

Fixed costs

Fixed costs are any costs that do not vary directly with the level of output. These costs are linked to time rather than to level of business activity. Fixed costs exist even if a business is not producing any goods or services. An example of a fixed cost is rent, which is usually calculated monthly, but will remain the same whether business is great or awful that month. The landlord doesn't care; they just want to be paid!

If a manufacturer can double output from within the same factory, the amount of rent will not alter, thus it is a fixed cost. In the same way, a seaside hotel has mortgage and salary costs during the winter, even though there may be very few guests. Given that fixed costs are inevitable, it is vital that managers bring in enough customers to keep the fixed costs covered.

In Figure 24.1, you can see that the firm faces fixed costs of £50,000 irrespective of the level of output.

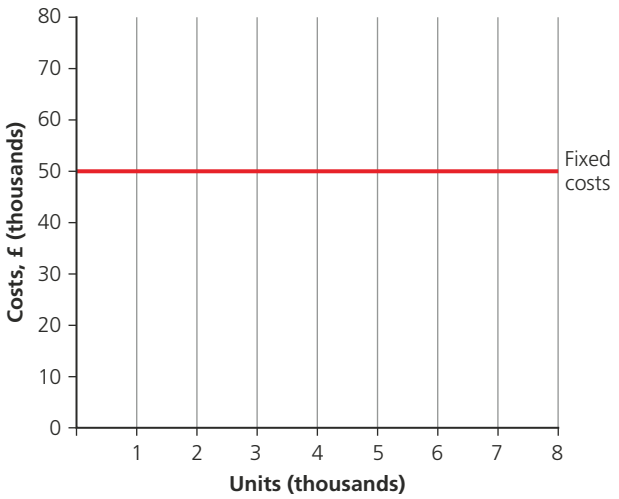

Figure 24.1 Fixed costs of £50,000 per year

Other examples of fixed costs include the uniform business rate (local taxes), management salaries, interest charges and depreciation.

In the long term, fixed costs can alter. A manufacturer may decide to increase output significantly. This may require renting additional factory space and negotiating

Key terms

Dynamic pricing: a strategy where businesses such as airlines, hotel chains and live event ticketing services use software that allows changing demand and supply levels to set ever-changing prices.

Fixed costs: these costs do not vary as output (or sales) vary.

loans for additional capital equipment. Thus rent will rise as may interest payments. So in the long term fixed costs may alter, but that in the short term they are – as their name suggests – fixed.

Real business

In southwest London, American diner Wafflejacks has recently invested heavily in electronic tables that work like giant iPads. Customers can call up the menu, or play a game of ice hockey, or find electronic crayons to draw a picture. The tables may cost £10,000 each, but they add value to the customer experience, especially for families with young children. Owners Adele and Stephan Theron have to face higher fixed costs, but higher revenues more than compensate. Customers stay longer, spend more and come more often. And in the future, customers will be able to order direct from their table, which will reduce the need for waiting staff. So, while one fixed cost rises, another should fall.

Figure 24.2 Wafflejacks

Variable costs

Variable costs are those costs which vary directly with the level of output. They represent payments made for the use of inputs such as labour, fuel and raw materials. If our manufacturer doubled output then these costs would double. A doubling of the sales of Innocent Drinks Strawberry Smoothies would require twice the purchasing of strawberries and bananas. There would also be extra costs for the packaging, the wage bill and the energy required to fuel the production line.

The graph in Figure 24.3 shows a firm with variable costs of £8 per unit of production. This means that variable costs rise steadily with, and proportionately to, the level of output. Thus a 10 per cent rise in output will increase **total variable costs** by the same percentage.

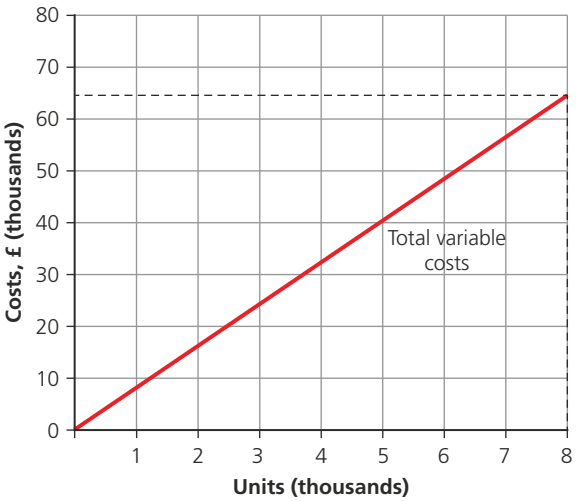

Figure 24.3 Variable costs of £8 per unit

However, it is not always the case that variable costs rise in proportion to output. Many small businesses discover that as they expand, variable costs do not rise as quickly as output. A key reason for this is that as the business becomes larger it is able to negotiate better prices with suppliers. Its suppliers are likely to agree to sell at lower unit prices when the business places larger orders.

Examples of some variable, fixed and hard-to-classify costs are given in Table 24.1.

Table 24.1 Some costs are easy to classify, some are hard

Variable costs	Fixed costs	Hard to classify
Raw materials	Rent	Delivery costs
Packaging	Heating and lighting	Electricity
Piece-rate labour	Salaries	Machine maintenance costs
Commission (percentage on sales)	Interest charges	Energy

Key terms

Variable costs: the costs of producing one unit (can be known as unit variable costs).

Total variable costs: all the variable costs of producing a specific output level; that is, variable costs per unit multiplied by the number of units sold.

Piece-rate labour: paying workers per item they make; that is, without regular pay.

Total costs

When added together, fixed and variable costs give the **total costs** for a business. This is, of course, a very important element in the calculation of the profits earned by a business.

The relationship between fixed, variable and total costs is straightforward to calculate but has some important implications for a business. If a business has relatively high fixed costs as a proportion of total costs, then it is likely to seek to maximise its sales to ensure that the fixed costs are spread across as many units of output as possible. In this way, the impact of high fixed costs is lessened.

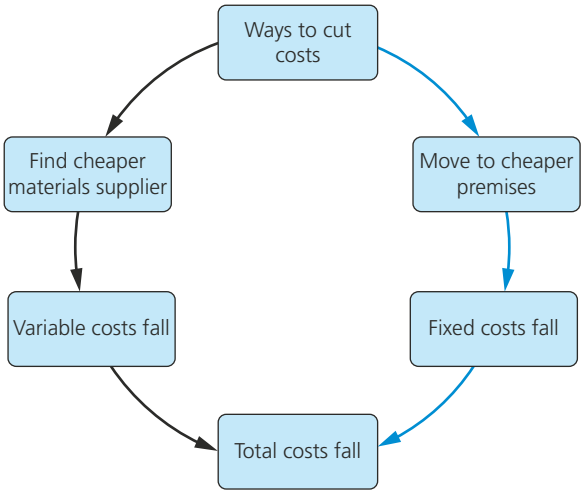

Figure 24.4 Logic chain: cutting costs

Key term

Total costs: all the costs of producing a specific output level; that is, fixed costs plus total variable costs.

24.4 Profits

Profit occurs when revenues are greater than costs. The key formula is:

Profit = total revenue – total costs

Calculating profits

Although the profit formula is simple (revenue – costs), it is easy to make mistakes when calculating the figures. The problems rarely come from calculating revenue; the hard part is getting total costs right.

'If you're not in business for fun or profit, what are you doing here?' Robert Townsend, the original business guru

Quantitative skills

Gwen and John's pasta restaurant charges £10 for three courses and has an average of 800 customers per week. The variable costs are £4 per customer and the restaurant has fixed costs of £3,400 per week. To calculate profit:

1 Calculate revenue:

Price × no. of customers

£10 × 800 = £8,000

2 Calculate total costs:

Fixed costs + total variable costs (no. of customers × variable costs per meal)

£3,400 + (800 × £4 = £3,200)

3 Calculate profit:

Total revenue – total costs

£8,000 – (£3,400 + £3,200) = £1,400 per week

See the Workbook section for exercises to practise this very important skill.

Five Whys and a How

Question	Answer
Why is it important for businesses to make a profit?	Because profit provides the long-term capital for reinvestment and for business expansion.
Why might a business want to separate its variable from its fixed costs?	Because it helps it to analyse the impact on profit of a change in demand or change in price.
Why would a firm be worried if its revenue had slipped below its total costs?	Because it would be making operating losses. In the short term that might be okay, but continual operating losses would force the company to close.
Why might a business choose to lower its prices?	Because it feels that the increase in sales volume will outweigh the loss in revenue caused by the price cut, pushing total revenue up.
Why might companies such as Aldi be willing to operate with low prices that provide low profits per item sold?	It's fine to have low profits per sale as long as you can sell masses of units. Aldi makes strong operating profits because its rate of sale is high.
How does revenue differ from profit?	Revenue is just the value of sales, without taking costs into account. Profit includes the deduction of costs.

Evaluation: revenue, costs and profits

When evaluating costs, revenues and profits for a new enterprise it is necessary to judge the likely accuracy of the forecast figures. It is also worth thinking about whether profits are the best measure of success for a new business. A successful first year of trading may see an enterprise gain a customer base and repeat orders by supplying at competitive prices. This may result in small profits initially while the business builds a reputation. Profits may become a more important measure of success in the longer term.

An assessment of the true worth of a business's performance as measured by its profits would also take account of the general state of the economy. Are businesses in general prospering, or is it a time of recession? They would also take into account any unusual circumstances such as, for example, the business being subject to the emergence of a new competitor.

Workbook

A Revision questions

(30 marks; 30 minutes)

1 Why may a business initially receive relatively low revenues from a product newly introduced to the market? (3)

2 State **two** circumstances in which a company may be able to charge high prices for a new product. (2)

3 For what reasons may a firm seek to maximise its sales revenue? (4)

4 If a business sells 4,000 units of brand X at £4 each and 2,000 units of brand Y at £3 each, what is its total revenue? (4)

5 Outline **two** reasons why firms need to know the costs they incur in production. (4)

6 Distinguish, with the aid of examples, between fixed and variable costs. (4)

7 Explain why fixed costs can only alter in the long term. (3)

8 Give **two** reasons why profits are important to businesses. (2)

9 State **one** advantage and **one** disadvantage that may result from a business deciding to lower the proportion of profits it distributes to its owners. (2)

10 State **two** purposes for which a business's profits could be used. (2)

B Revision exercises

DATA RESPONSE 1

(30 marks; 30 minutes)

1 During the summer weeks Devon Ice Cream has average sales of 4,000 units a week. Each ice cream sells for £1 and has variable costs of 25p. Fixed costs are £800.

a) Calculate the weekly total costs for the business in the summer. (3)

b) Calculate Devon Ice Cream's weekly profit in the summer. (3)

2 a) If a firm sells 200 Widgets at £3.20 and 40 Squidgets at £4, what is its total revenue? (3)

b) Each Widget costs £1.20 to make, while each Squidget costs £1.50. What are the total variable costs? (3)

c) If fixed costs are £300, what profit is the business making? (3)

3 'Last week our sales revenue was £12,000, which was great. Our price is £2 a unit, which I think is a bit too cheap.'

a) How many unit sales were made last week? (2)

b) If a price rise to £2.25 cuts sales to 5,600 units, calculate the change in the firm's revenue. (4)

4 BYQ Co. has sales of 4,000 units a month, a unit price of £4, fixed costs of £9,000 and unit variable costs of £1. Calculate its profit. (4)

5 At full capacity output of 24,000 units, a firm's costs are as follows:

- managers' salaries £48,000
- materials £12,000
- rent and rates £24,000
- piece-rate labour £36,000

a) What are the firm's total costs at 20,000 units? (4)

b) What profit will be made at 20,000 units if the selling price is £6? (1)

AQA A-level

Business

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Ian Marcousé is one of the UK's leading Business educators, known for turning complex ideas into clear, confident understanding. As a long-time examiner and bestselling author, he has helped millions of A-level students master the subject and achieve top grades. His work continues to shape how Business is taught in classrooms across the country.

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