Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.6 Revenues, Costs, Profits and Cash

1.6.3 Profit and loss

Notes

Profit as an incentive in a competitive market: market entry and exit

Profit acts as a signal in the market, by giving firms an incentive to enter or leave the market. A firm is likely to enter a market where high profits are being made. This is because they see the potential for making profits themselves. However, it is not always easy to just enter a market. If there are high barriers to entry, it is going to be hard to enter the market.

The price acts as a signal to consumers and new firms entering the market. The price changes show where resources are needed in the market. A high price signals firms to enter the market because it is profitable. However, this encourages consumers to reduce demand and therefore leave the market. This shifts the demand and supply curves.

For the entrepreneur in a firm, the incentive for taking risks is profit. An entrepreneur wants to avoid loss and gain profit, which makes them want to innovate. They can reduce their production costs and improve the quality of their products. Entrepreneurs seek to maximise their profits.

Statement of comprehensive income (profit and loss account)

The statement of comprehensive income (profit and loss account) shows the revenue and expenses of a firm. It gives an overview of the firm's financial position.

Net income is also known as profit or loss. This can be used as a measure of a firm's performance. The components of this are income and expenses.

An increase in income increases the inflow of money to the firm. If a firm has larger expenses, there will be more outflows. This would worsen the firm's financial position.

How firms calculate and measure profitability:

○ Gross profit margin

Gross profit is calculated by **total sales minus the cost of the goods sold**.

The gross profit margin is calculated by **gross profit divided by sales**. This is expressed as a percentage.

The gross profit margin can be increased by raising prices and decreasing costs. However, firms might risk losing sales if prices are increased. Costs can be lowered by becoming more efficient or reducing the cost of raw materials. However, firms have to be careful not to compromise on quality.

○ Operating profit margin

A firm's operating profit is the profit earned from the core business operations. This excludes profit from investment, interest and taxes. It is also called earnings before interest and tax (EBIT).

It is calculated as **operating revenue - costs of goods sold - operating expenses - depreciation and amortisation**.

○ Profit for the year (net profit) margin

This represents the number of sales left after all expenses, interest and taxes have been take off. This is calculated by total revenue – total expenses.