Profit versus Profitability

Making extra profit is not always about increasing prices

The two words seem the same, one being derived from the other; and in most cases both refer to money. Profit is the extra gleaned from selling at a higher rate than the cost price. Profitability is the ability to yield a profit. If the difference is still not clear, I suppose the best way to explain what I'm talking about is with an example.

A greengrocer buys a load of apples for $100.00. The purchase weighs 100 kilos, so by selling them one kilo at a time each bag would have cost $1.00. In order to make a profit on subsequent sales an amount needs adding. As this is often a percentage, let's assume, initially anyway, that 20% is deemed a reasonable mark-up, bringing the resale price to $1.20 per bag. In order to run a successful business, though, expenses such as overheads have to be considered. There may be rent for the premises; power for lighting; certain taxes; the cost of the bags to put the apples in; and, unless it is a one-person operation, staff have to be paid. Taking these things into account, that 20% on the top will have diminished to a degree. To compensate, the greengrocer increases the margin to 25%. The apples now go on sale for $1.25 a bag. Always assuming the entire load is sold, the profit would be $25.00. Taking off the allowance for overhead expenses brings it down to $20.00.

Our greengrocer, however, is a greedy one who wants to make a bigger profit. Easy – increase the mark-up. The apples are now $1.50 a bag which should equate to an overall profit of $50.00: twice as much as it would have been at the cheaper rate. That's the idea, anyway. The trouble is that another nearby fruit and vegetable shop, which bought apples from the same source at the same price, decides to sell them for a more reasonable $1.25 a bag; and word gets around. It eventually dawns that something is wrong because, after selling only ten bags of apples, customers stop coming to buy them from our greengrocer. And why wouldn't they, when they can get them down the road 25 cents a bag cheaper? The end of this particular story is good for the fruit and vegie shop which sold all of its apples for a profit of $25.00. Not so much so for our greedy profiteer who sold the ten bags for $15.00, while the remainder went rotten and had to be thrown out - a loss of $85.00.

The lesson to be learned from this is that profit is a combination of the mark-up added to individual items multiplied by the number sold; in effect, a greater volume of sales encouraged by a lower price can often increase the overall profit. Maybe someone should have told the airlines about this. Certainly they have enormous overheads - fuel, staffing, maintenance, advertising; the list goes on. The outlay has to be factored into the price charged for seats on a plane in order for a flight to turn a profit; and this ideal is usually arrived at on the assumption that all seats would be filled. Should that not be the case the

remedy for airline A is simple – increase the price of each seat to compensate.

Unfortunately the strategy doesn't take into account that their customers aren't stupid. So, unless a particular flight is absolutely necessary, many will refuse to pay the extra and give it a miss; or they may choose to fly with a rival airline B that is cheaper. The result for A is more empty seats on a flight that is less profitable. On certain occasions, airlines announce special discounted prices for a limited period. I imagine they would have no problem filling all seats on every flight covered by the temporary ploy; and I very much doubt that they do so at a loss. The only time any kind of loss might be considered is by conducting a promotion scheme to win back customers for now, in the hopes that they remain loyal when the prices eventually go back up again; as they will.

Many businesses employ similar tactics to bring in customers by introducing something called a lost leader. Stores and supermarkets often advertise specials on specific items selling for a really low price that is too good for customers to pass up. If they actually make a loss on these specials it has already been factored in as a lost leader intended to bring in customers who will hopefully buy not only the heavily discounted goods, but also other products that are the usual price with bigger mark-ups yielding greater profits. Balanced against the loss on specials, the stores will expect that this swings-and-roundabouts practice is a winner regarding overall profitability. The fly in the ointment regarding the strategy is customer savvy. Those mindful of their budget may well buy only the specials and finish their shop elsewhere at venues that don't make a practice of hiking up profit margins. Who wins then?

The message should be clear to anyone selling whatever in the hopes of making a profit – beware of over-pricing. Cars are a classic example. Try to get too much in order to recover the expense of getting them up to scratch, plus a bit, and they might not sell at all. Better to make a little than nothing. Even antiques and collectables which are difficult to price in the first place can be a trap for casual punters. In many cases the value to buyers varies according to reasons and desire when it comes to how much an individual is prepared to pay. So, purchasing a 17th century snuff box because it should turn a good profit doesn't mean it will if nobody wants it, or simply can't afford the price being asked.

Businesses and individuals need to be aware that there is more to making money than just sticking a good mark-up on the cost of a purchase; then expecting prospective buyers to appreciate that as well as paying for the item, they are also contributing to the seller's overall expenses. Profits may be the ultimate goal; but profitability must be considered to ensure the score is a winning one.

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