Module- V

Profit Maximization and Pricing Theories

Definition

Profit maximization is the capability of a business or company to earn the maximum profit with low cost which is considered as the chief target of any business and also one of the objectives of financial management. According to financial management, profit maximization is the approach or process which increases the profit or Earnings per Share (EPS) of the business. More specifically, profit maximization to optimum levels is the focal point of investment or financing decisions.

"Profit maximization may be the 'end' but the means to achieve this end, is what matters, and that distinguishes a company in the corporate world and the market." – Henrietta Newton Martin

Benefits of Profit Maximization:

- **Economic Existence:**

The foundation of the profit maximization theory is profit and profit is a must for the economic existence of any company or business.

- **Performance Standard:**

Profit determines the standard of performance of any business or company. When a business is unable to make profits it fails to fulfill its chief target and causes a risk to its existence.

- **Economic and Social Well-being:**

Profit maximization theory indirectly plays a role in economic and social well-being. When a business makes a profit, it utilizes and allocates resources properly which in turn results in the payments for capital, fixed assets, labor and organization. In this way, economic and social welfare is performed.

Drawbacks of Profit Maximization:

- **The Vagueness of the Profit Concept:**

The concept of profit is indefinite because different people may have a different idea about profit, such as profit can be EPS, gross profit, net profit, profit before interest and tax, profit ratio, etc. Particularly, no definite profit-maximizing rule or method exists in reality.

- **Does Not Consider Time Value of Money:**

The profit maximization theory only states that higher the profit better the performance of the business. The theory only considers profit without considering the time value of money. The concept of the time value of money tells that a certain unit of money today will not be equal to the same unit of money a year later.

- **Does Not Consider the Risk:**

Any business decision only considering profit maximization model ignores the involved risk factor which may be harmful to the existence of the business in the long-run. Because if the business is incapable of handling the higher risk, its survival will be in question.

- **Does Not Consider the Quality:**

Intangible benefits e.g. image, technological advancements, quality, etc. are not considered in the profit maximization approach which is considered as one of the biggest drawbacks. These intangible assets have a mentionable role in creating value for the business which cannot be ignored. Profit maximization theory is based on a traditional viewpoint but the modern business and financial concept value wealth maximization much more than profit maximization.

How to Achieve Profit Maximization:

1. **Increasing Sales-revenue:**

   Sales-revenue can be increased in the following profit-maximizing ways.

- Increasing sales quality by applying better marketing strategies, quality improvement, a thorough market study to assess that from which segment more money is coming to the business and concentrate in making more sales from those products or services. You can also borrow the best marketing strategy from your competitors, or similar businesses.
- Insisting existing customers to buy extra services or products.
- Diversification by selling a wider variety of products or services.
- Revising pricing of products or services to achieve increased sales-revenue. You can charge a higher price for your product or service if its better in quality. Temporarily you can lose a few clients but according to researchers, people prefer a quality product or services even by paying a little high.
- Motivating employees can also increase sales-revenue because satisfied employees will perform better and help to produce better products and services which will help the company to earn a profit. Better performance appraisal techniques such as announcing employee of the month, promotion, increment, etc. or going out for picnic, lunch, arranging cultural programs, etc. can motivate employees.
- Educating all customers both existing and potential for your product or service by TV or radio or newspaper advertisements, digital marketing or email-marketing or social-media marketing, publishing and distributing leaflets, posters, banners, etc.

2. **Cost-cutting:**

Cost-cutting can be done in the following profit-maximizing manners.

- Analysis of the full expenditure of money to different sectors.
- Negotiate with suppliers for cheaper prices especially when buying in large quantities.

- ❖ Manufacturing process should be more efficient to reduce wastage. Technologies which saves time and expands production should be applied.
- ❖ Looking for a new cost-effective energy supplier because a large amount of money is spent on the energy sector.
- ❖ Outsourcing: A business cannot do all the tasks by itself or a small business cannot hire a talented people on a full-time basis at a higher Outsourcing can save a lot of money here. Full-time employees will be engaged in revenue-generating projects and simple tasks can be done by outsourcing or through freelancers.

Business people can maximize profit by following the above steps keeping time value of money, the risk and quality factor in consideration.

The profit maximisation theory is based on the following assumptions:

- ❖ The objective of the firm is to maximize its profits where profits are the difference between the firm's revenue and costs.
- ❖ The entrepreneur is the sole owner of the firm.
- ❖ Tastes and habits of consumers are given and constant.
- ❖ Techniques of production are given.
- ❖ The firm produces a single, perfectly divisible and standardized commodity.
- ❖ The firm has complete knowledge about the amount of output which can be sold at each price.
- ❖ The firm's own demand and costs are known with certainty.
- ❖ New firms can enter the industry only in the long run. Entry of firms in the short run is not possible.
- ❖ The firm maximizes its profits over some time-horizon.
- ❖ Profits are maximized both in the short run and the long run.

Baumol s Sales Maximization Model

Baumol, 'The sales maximization goal says that managers of firms seek to maximize their sales revenue subject to the constraint of earning a satisfactory profits. "

The above definition maintains that when the profits of firms reach a level considered satisfactory by the shareholders then the efforts of the managers are directed to maximize revenue by promoting sales instead of maximizing profit.

Baumol raised serious questions on the validity of profit maximization as an objective of the firm. He stressed that in competitive markets, firms would rather aim at maximizing revenue, through maximization of sales. According to him, sales volumes, and not profit volumes, determine market leadership in competition. He further stressed that in large organizations, management is separate from owners. Hence there would always be a dichotomy of managers' goals and owners' goals. Manager's salary and other benefits are largely linked with sales volumes, rather than profits.

Following arguments are given in favour of maximization of sales goal:

i. More Realistic: Goal of maximization of sales is a more realistic goal- In fact, firms accord more importance to the goal of sales maximization than profit maximization. It is so because success of a firm is generally judged from its total sales. According to Ferguson and Krupp’s, 'Among the various alternatives advanced, Baumoul’s thesis has great advantage — it raises the other models in the direction of reality and plausibility while still permitting a rather general theoretical analysis."

ii. More Practical: Revenue maximization thesis of Baumol is more practical. It is so because goal of revenue (Sales) maximization leads to more production which, in turn, leads to fall in price. As a result, consumers' welfare is promoted. They also endorse this goal of the firms.

iii. More Availability of Loans: At the time of sanctioning loan to a firm, financial institutions mainly consider its sales. Prospects of loans are bright for such firms as have large total sales.

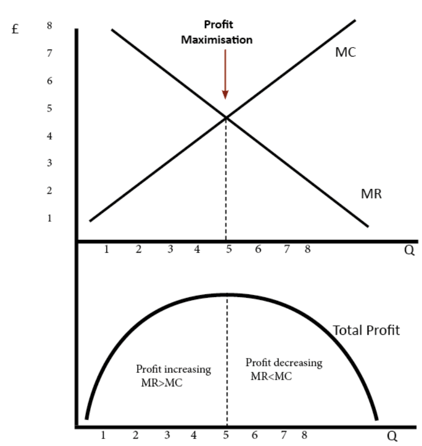
iv. Strong Position in the Market: Maximum sales of a firm symbolize its strong position in the market. Sales of a firm will be large only in that situation when consumers like its production, firm has more competitive power and has been expanding. All these features are indicative of the progress of the firm.

v. More Advantageous to the Managers: It is more to the advantage of the managers that the firm should aim at sates maximization. This way their credibility enhances in the market. Maximum sales is a reflection of the competence of the managers It has a favorable effect on their wages. Firm is in a position to offer higher wages to the employees. Consequently, employer-employee relations become more cordial. II is the constant endeavor of the managers to maximize the sales of the firm after attaining a given level of profit.

Profit Maximization

- An assumption in classical economics is that firms seek to maximize profits.
- Profit = Total Revenue (TR) – Total Costs (TC).
- Therefore, profit maximization occurs at the biggest gap between total revenue and total costs.
- A firm can maximize profits if it produces at an output where marginal revenue (MR) = marginal cost (MC)

Diagram of Profit Maximisation



To understand this principle look at the above diagram.

- ❖ If the firm produces less than Output of 5, MR is greater than MC. Therefore, for this extra output, the firm is gaining more revenue than it is paying in costs, and total profit will increase.
- ❖ At an output of 4, MR is only just greater than MC; therefore, there is only a small increase in profit, but profit is still rising.
- ❖ However, after the output of 5, the marginal cost of the output is greater than the marginal revenue. This means the firm will see a fall in its profit level because the cost of these extra units is greater than revenue.

Baumol's Static Models:

The basic assumptions of the static models:

1. The time-horizon of a firm is a single period.
2. During this period the firm attempts to maximise its total sales revenue (not physical volume of output) subject to a profit constraint.
3. The minimum profit constraint is exogenously determined by the demands and expectations of the shareholders, the banks and other financial institutions
4. 'Conventional' cost and revenue functions are assumed. That is, Baumol accepts that cost curves are U-shaped and the demand curve of the firm is downward-sloping.

We will examine four models:

- ❖ A single-product model, without advertising.
- ❖ A single-product model, with advertising.
- ❖ A multiproduct model, without advertising.
- ❖ A multiproduct model, with selling activities.

Baumol's Dynamic Model:

The static single-period model developed in the previous section is only an introduction to the more ambitious multi period analysis attempted by Baumol. The most serious weakness of the static model is the short time-horizon of the firm and the treatment of the profit constraint as an exogenously determined magnitude. In the dynamic model the time-horizon is extended and the profit constraint is endogenously determined.

The Assumptions of the Dynamic Model:

1. The firm attempts to maximize the rate of growth of sales over its lifetime.
2. Profit is the main means of financing growth of sales, and as such is an instrumental variable whose value is endogenously determined.
3. Demand and costs have the traditional shape: demand is downward-falling and costs are U-shaped.

Profit is not a constraint (as in the static model) but an instrumental variable, a means whereby the top management will achieve its goal of a maximum rate of growth of sales.

Growth may be financed by internal and external sources. However, there are limits to the external sources of finance. Thus profits will be the main source for financing the rate of growth of sales revenue. For simplicity we may actually assume that growth will be entirely financed by profits.

Williamson's Model of Managerial Discretion

Williamson[1] argues that managers have discretion in pursuing policies which maximize their own utility rather than attempting the maximization of profits which maximizes the utility of owner-shareholders. Profit acts as a constraint to this managerial behavior, in that the financial market and the shareholders require a minimum profit to be paid out in the form of dividends, otherwise the job security of managers is endangered.

Williamson states that managers apply discretion in making and implementing policies to maximize their own utility rather than trying for the maximization of profit which ultimately maximize own utility subject to minimum profit. Profit works as a limit to the top managers' behavior in the sense that the financial market and the shareholders require a minimum profit to be paid out in the form of dividends, otherwise the job security of managers is put in danger. Hence, managers look at their self-interest while making decision on price and selling quantity of output. Manager's decision on price and output differs from the decisions of profit maximizing firm.

Williamson's model suggests that manager's self-interest focuses on the achievement of goals in four particular areas, namely:

1. High salaries
2. Staff under their control
3. Discretionary investment expenditures
4. Fringe benefits (i.e., additional employee benefit: an additional benefit provided to an employee, for example, a company car or health insurance)

This model depends on some assumptions which are:

1. Weakly competitive environment.
2. A divorce of ownership from control of firm (manager is free to perform any action)
3. A capital market imposes minimum profit constraint (manager's work for minimum profit imposed by a capital market).

According to Williamson, managers want 'utility' which is the same things as happiness or satisfaction. Top managers and chief executive officers reveal expenditure preference that is they derive utility expenditure on staff (S), managerial emoluments (M), and discretionary profits. The discretionary profit is defined as the profit level higher than the level necessary for long-term survival.

The managerial utility function includes such variables as salaries, security, power, status, prestige and professional excellence. Of these variables, only the first variable 'salaries' is measurable. The others are non pecuniary. Therefore, in order to make them operational, they must be expressed in terms of other variables with which they are related and which are measurable.

According to Williamson, "Managerial Utility function may be expressed as follows:

U = f (S, M. ID)

It will be read as: Managerial utility is a function (f) of additional expenditure on staff, managerial salary and discretionary investment.

(Here, U = managerial utility; S = additional expenditure on staff; M = managerial payment or salary and ID = discretionary investment).
Economics Theories
Managerial utility function maximises the utility of the managers rather than profits of the firm. The manager is expected to follow policies which maximise the following components of his utility function.

i. Expansion of Staff:

The manager will like to increase the quality and number of staff reporting to him. This will lead to an increase in the salary of the staff. More staff are valued because they lead to the manager getting more salary, more prestige and more security.

ii. Increase in Managerial payment or salary:

Managerial Utility also depends on managerial payment. It includes facilities like entertainment allowance, luxurious office, staff car, company phone, etc. Expenditure of this nature reflects to a large extent the prestige, power and status of the manager.

iii. Discretionary Power of Investment:

Managerial utility also depends on the discretion of the manager to undertake investment beyond those required for normal operations. The manager is in a position to invest in advanced technology and modem plants. Such investments may or may not be economically efficient. These investments may be undertaken for the self-satisfaction of the manager.

According to the theory, in a firm, shareholders and managers are two separate groups. The firm tries to get maximum returns on investment and get maximum profit, whereas managers try to maximize profit in their satisfying function.

At last, Williamson's managerial discretion theory shows the utility function of a manager. In this theory, the firm will try to get maximum returns or maximum profit where as manager try to maximum utility satisfying function. They are in equilibrium when the utility has maximum amount.

MARRIS'S THEORY GROWTH MAXIMISATION

Managers may decide to adopt a longer term standpoint and focus on growth maximization rather than maximizing short run revenues. Growth is usually measured in terms of growth of sales revenue but can be to measure the capital value of the firm. It is felt that the alternative method is less reliable as it will be influenced by stock market trends. A firm looking to maximize growth should be clear about the period that this will be delivered over.

Benefits

Large firms have more influence over market price as they are large enough to be price setters. Large firms also often enjoy economies of scale. This means that a business has lower unit costs because of its large size. They can buy raw materials cheaply in bulk and also spread the high cost of marketing campaigns and overheads across larger sales.

Growth by internal expansion

Internal growth is achieved by increasing sales which requires an increase to productive capacity. Sales are likely to be maximized through product promotion and introduction of new products to the market and new investment will be required to increase productive capacity. In short-run the firm can finance growth by retaining profits, a share issue or borrowing. The amount of finance that the firm can raise will determine how quickly the firm can grow. In the long run rapid growth may lead to increased profits assuming economies of scale can be realised and it can take a larger share of the market. Further growth can be financed from these profits.

GROWTH THROUGH VERTICAL INTEGRATION

Vertical integration occurs when firms merge at different stages of the production cycle and can be used where market conditions make growth through increased sales difficult. There are two types of integration - backwards and forwards. Backwards occurs where the merger nearer to the source of the product, such as a car producer buying a steel manufacturer. Forward occurs where the firm merges to move nearer to the consumer, such as a car producer buying a chain of car showrooms.

Horizontal integration occurs when firms merge at the same stage of production, such as a merger between two car producers, or two car showrooms. Horizontal integration is also referred to as lateral integration.

Growth through diversification

Diversification is a good strategy to adopt when the market is saturated, stagnant or in decline. Virgin is a good example of a diversified firm. Interests range from trains to aircraft to wine to cosmetics to space travel. Diversification spreads risk as it produces multiple products completing in multiple markets.

Growth by Merger

Merger can be a mutual agreement or a takeover. There are three types of mergers: horizontal, vertical and conglomerate. A number of possible motives for why one firm wants to take over another

Economies of Scale:

Reduction in costs can be achieved through 'rationalization'. However, evidence suggests that this is not often achieved as the level of 'rationalization' needed is not introduced.

Growth:

Quicker than internal expansion and as the firm acquires additional capacity and consumer demand. A cautionary point worth noting -growth-maximising firms with low profit and low stock market value can be attractive to other firms.

Increased market valuation:

Merger can increase stock market valuation of the merger firm. However, there is limited evidence to suggest that a capital gain is achieved.

Monopoly power:

Driving force is to reduce competition and gain greater market power and profits by taking out the competition.

Reduce uncertainty:

Two major sources of uncertainty – behaviour of firms and economic environment. Merger reduces rivals and in turn uncertainty and in a period of boom merger with other firms provides some protection.

Opportunity:

Unforeseen opportunity that has arisen suddenly.

Strategic alliances with other firms can help a firm achieve growth fairly quickly and in principle at a low cost. Several types of alliances exists (Joint ventures, Consortia, Franchising, Subcontracting and Networks). Alliances are seen as an opportunity to expand operations at pace without the challenges of a more aggressive approach that can be lengthy.

Benefits:

- Exploit knowledge of existing player in market.
- Pool capital
- Easier to generate finance

Going global is simply an extension of its domestic strategy that offers the opportunity to expand its markets and spread risk - it is no longer reliant on a single market to be successful. The firm can achieve economies of scale through this expansion through access to cheaper labour or supply.

The Marris model is based on the following assumptions:

1. It assumes a given price structure.
2. Production costs are given.
3. There is no oligopolistic interdependence.
4. Factor prices are constant.
5. Finns are assumed to grow through diversification.
6. All major variables such as profits, sales and costs are assumed to increase at the same rate.The goal of the firm in Marris's model[1] is the maximisation of the balanced rate of growth of the firm, that is, the maximisation of the

rate of growth of demand for the products of the firm, and of the growth of its capital supply.

Full-Cost Pricing

Full-cost pricing seeks to include every cost of running a business in the cost of producing goods. These costs include rent, a fixed cost or initial outlays of money for purchasing and renovating a location, which is a sunk cost. The pricing manager attributes total costs of the business equally to each item produced for sale. Full costs are higher than marginal costs, because they include more than just the variable costs associated with production.

Full-Cost Issues

Full-cost pricing generally fails to achieve the theoretically optimal profit-maximizing price. This is because the manager will include sunk and fixed costs in the decisions about how much of each item to produce and what their prices should be. However, those costs, by definition, do not vary with the level of production, so they should not affect production-level decisions. On the other hand, full cost is relatively easy to measure -- simply add up all the costs of the business and divide by the amount of items the owner or manager wants to sell.

Full-cost pricing is one of many ways for a company to determine the selling price of a product. To use this pricing method, you add together all costs of creating and selling the product (including material costs, labor costs, selling and administrative costs and overhead costs) and a markup percentage to allow for a profit margin. You then divide this number, which should include the price of all units produced, by the number of units you expect to sell.

The full-cost calculation is simple. It looks like: (total production costs + selling and administrative costs + markup) ÷ the number of units expected to sell.

Objectives of Full-Cost Pricing Method

The objective of full-cost pricing method is to cover costs and to derive a pre-determined percentage of profit. The percentages added to the cost are called margins or mark-ups. The percentages added differ widely from firm to firm, industry to industry and even from product to product in the same industry. Pricing of this type is based on full absorption of costs plus a mark-up for profit.

Advantages of full cost pricing

The following are some of the advantages of full cost pricing method.

1. Full cost pricing method is very simple in the calculation of price of export.

2. Assurance of reasonable return to the exporter.

3. Price competition can be avoided in full cost pricing as all exporters, more or less, use the same pattern of pricing.

4. No possibility of loss from export because all costs are recovered.

5. Cost data collection can be avoided in full cost pricing, because all cost data required for the purpose is available with the exporting fir.

6. It helps in setting fair and plausible prices.

7. It is easy for application by all types of firms whether single-product or multi-product firms.

8. This method safeguards the interest of the firm against risks when the demand is uncertain.

9. It is economical for decision-making.

10. Full-cost pricing, if adopted by all businessmen within the industry may help protect the firms against price-wars or self-damaging price-competitions and at the same time provide some flexibility in adjusting prices to cost changes.

11. Full cost pricing method is the best while dealing with uncertainty and ignorance.

Disadvantages of full cost pricing

The following are some of the disadvantages of full cost pricing method.

1. The so called advantages are only deceptive. Full cost pricing completely ignores all aspects of competition and strategy adopted by

competitors. It neglects the demand factor. Calculation of average fixed cost is difficult, particularly in the

2. Multi-product firm.
3. Full cost pricing considers only historical costs data and not the future cost data for allocation of costs to products.
4. This method is based on circular reasoning: i.e., price determines the quantity demanded; price charged is dependent upon cost per unit and the cost, in turn depends upon the quantity demanded.
5. It ignores marginal or incremental cost and uses average costs instead.
6. This method totally ignores the influence of demand.
7. Full cost pricing method fails to reflect the forces of competition adequately.
8. Cost is regarded the main factor influencing the price.
9. Undue importance is given for the precision of allocating of costs.
10. The method is based on circular reasoning, i.e., price determines quantity demanded; price charged is dependent upon cost per unit and the cost, in turn, depends upon the quantity demanded.
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Marginal Cost Pricing

In marginal cost pricing, the benchmark cost for each outcome is the cost required to produce it. This cost does not include fixed costs of the business, such as rent payments, which do not vary with the level of production. Marginal cost is only the cost of the labor, material and other direct inputs for producing each item. Under marginal cost pricing, the business would first decide how much to produce and then set its price based on the marginal cost of the last unit it produces.

Advantages and disadvantages of marginal cost pricing

Advantages

- It is a relatively simple pricing method - quick to calculate and easy to implement
- Can help to smooth fluctuations in demand.
- It can be very useful where the firm has spare capacity and may not be able to put its resources to other, perhaps more profitable, uses.
- Can be a useful way to attract other different market segments into the market e.g. low peak train travelers may be attracted by lower prices and only travel during the day because of low prices - they may not otherwise have travelled.
- Can be a good way to remain in business and price-competitive in a time of difficult trading. Prices can then be raised later when the economic situation improves.
- Cost data collection can be avoided in full cost pricing, because all cost data required for the purpose is available with the exporting fir.
- It helps in setting fair and plausible prices.
- It is easy for application by all types of firms whether single-product or multi-product firms.
- This method safeguards the interest of the firm against risks when the demand is uncertain.
- It is economical for decision-making.

Disadvantages

- Not sustainable as a long-term pricing strategy as the firm will need to recover the full costs of production.
- Can result in lower price expectations and make it more difficult to raise prices again at a later stage.

- If markets are not fully separated then there can be leakage between the markets with different prices. Customers who might have paid a higher price may take advantage of the lower marginal cost price.
- It neglects the demand factor.
- Calculation of average fixed cost is difficult, particularly in the multi-product firm.
- Full cost pricing considers only historical costs data and not the future cost data for allocation of costs to products.
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Cost Accounting

Cost accounting is an accounting process that measures all of the costs associated with production, including both fixed and variable costs. The purpose of cost accounting is to assist management in decision-making processes that optimize operations based on efficient cost management.

Concept of Costs

In order to understand the general concept of costs, it is important to know the following types of costs:

1. Accounting costs and Economic costs
2. Outlay costs and Opportunity costs
3. Direct/Traceable costs and Indirect/Untraceable costs
4. Incremental costs and Sunk costs
5. Private costs and Social costs
6. Fixed costs and Variable costs

Concept of Costs in terms of Treatment

1. Accounting costs

Accounting costs are those for which the entrepreneur pays direct cash for procuring resources for production. These include costs of the price paid for raw materials and machines, wages paid to workers, electricity charges, the cost incurred in hiring or purchasing a building or plot, etc.

2. Economic costs

There are certain costs that accounting costs disregard. These include money which the entrepreneur forgoes but would have earned had he invested his time, efforts and investments in other ventures. Economic costs help the entrepreneur calculate supernormal profits, i.e. profits he would earn above the normal profits by investing in ventures other than his.

Concept of Costs in terms of the Nature of Expenses

1. Outlay costs

The actual expenses incurred by the entrepreneur in employing inputs are called outlay costs. These include costs on payment of wages, rent, electricity or fuel charges, raw materials, etc.

2. Opportunity costs

Opportunity costs are incomes from the next best alternative that is foregone when the entrepreneur makes certain choices.

For example, the entrepreneur could have earned a salary had he worked for others instead of spending time on his own business. These costs calculate the missed opportunity and calculate income that we can earn by following some other policy.

Concept of Costs in terms of Traceability

1. Direct costs

Direct costs are related to a specific process or product. They are also called traceable costs as we can directly trace them to a particular activity, product or process.

They can vary with changes in the activity or product. Examples of direct costs include manufacturing costs relating to production, customer acquisition costs pertaining to sales, etc.

2. Indirect costs

Indirect costs, or untraceable costs, are those which do not directly relate to a specific activity or component of the business. For example, an increase in charges of electricity or taxes payable on income. Although we cannot trace indirect costs, they are important because they affect overall profitability.

Concept of Costs in terms of the Purpose

1. Incremental costs

These costs are incurred when the business makes a policy decision. For example, change of product line, acquisition of new customers, and upgrade of machinery to increase output are incremental costs.

2. Sunk costs

Suck costs are costs which the entrepreneur has already incurred and he cannot recover them again now. These include money spent on advertising, conducting research, and acquiring machinery.

Concept of Costs in terms of Payers

1. Private costs

These costs are incurred by the business in furtherance of its own objectives. Entrepreneurs spend them for their own private and business interests. For example, costs of manufacturing, production, sale, advertising, etc.

2. Social costs

As the name suggests, it is the society that bears social costs for private interests and expenses of the business. These include social resources for which the firm does not incur expenses, like atmosphere, water resources and environmental pollution.

Concept of Costs in terms of Variability

1. Fixed costs

Fixed costs are those which do not change with the volume of output. The business incurs them regardless of their level of production.

. Examples of fixed costs

- Rent
- Office salaries
- Advertising
- Insurance
- Depreciation

2. Variable costs

These costs will vary depending upon the output that the business generates. Less production will cost fewer expenses, and vice versa, the business will pay more when its production is greater. Expenses on the purchase of raw material and payment of wages are examples of variable costs.

Example of variable costs

- Direct labour
- Raw materials and components
- Packaging costs
- Royalties

1. Real Cost:

The term "real cost of production" refers to the physical quantities of various factors used in producing a commodity.

In other-words—Real cost signifies the aggregate of real productive resources absorbed in the production of a commodity or a service.

Marshall has described "real cost" as the production of a commodity generally requires many different kinds of labour and the use of capital in many forms.

2. Selling Costs:

Selling costs are the costs of marketing, advertisement and salesmanship. These costs are incurred to attract customers, expand market and capture more business and retain the existing business. These costs are the essential costs of the competitive economy.