Measuring Economic Profit

Chapter 9-3

Firms Maximize Profit

• Profit is the difference between total revenue and total cost.
  
  \[ \text{Profit} = \text{total revenue} - \text{total cost} \]

Firms Maximize Profit

• Economists and accountants measure profit differently.
  
  – Accountants focus on explicit costs and revenue.
  – Economists focus on both explicit and implicit costs and revenue.

Firms Maximize Profit

• For an economist, total cost is explicit payments to factors of production plus the opportunity cost of the factors provided by the owners of the firm.

Firms Maximize Profit

• Economists define total revenue as the amount a firm receives for selling its good or service plus any increase in the value of the assets owned by firms.

Firms Maximize Profit

• For economists:
  
  \[ \text{Economic profit} = \frac{\text{(explicit and implicit revenue)}}{\text{(explicit and implicit cost)}} \]
Accounting Profit

- The profit figure reported in annual reports and income statements is **accounting profit**:

  \[
  \text{Accounting Profit} = PQ - (\text{cost of land}) - (\text{cost of labor}) - (\text{cost of capital})
  \]

Economic Profit

- Accounting profit does not include the cost of ownership – called equity capital.
- Economic profit includes all opportunity costs.

  \[
  \text{Economic profit} = \text{accounting profit} - \text{cost of equity capital}
  \]

Economic Profit

- Economists refer to a firm that subtracts value, whose cost of equity capital is greater than its accounting profit, as having **negative economic profit**.

- A firm that neither adds value nor subtracts it is a firm whose revenue is sufficient to pay the costs of inputs, but generates nothing in excess of this. This result is referred to as **zero economic profit**.

- If a firm is returning more to its owners than the owners’ opportunity cost, the firm is said to be earning a **positive economic profit**.

Role of Economic Profit

- Economic profit operates as a coordinating factor in the economy.
  - When a firm earns a positive economic profit, investors in the firm are earning better returns than they normally would with competing investments.
  - Other investors will want to invest in firm, too. As a result, resources will flow to where they earn more.