The difference between economic profit and accounting profit

Business, Accounting

When it comes to business decisions, there are many ways to analysis the financial status of a firm. What guidelines determine profit margin? Who uses these guidelines? How is profit used to analysis a firm and its business decisions? This paper will discuss two terms that are used to define profit: accounting profit and economic profit. The first term is called accounting profit which uses the equa-tion.

The second term for profit is economic profit. Economic profit adds another element to the equation when determining profit. It is as follows.

Both Economic and accounting profit have their place in analysis of a firm's business activity. To have a clearer understanding of accounting profit and economic profit, a few terms need to be de-fined. According to the text, Economics Today- the micro view, explicit costs are defined as the ex-penses that business managers must take account of because they must actually be paid out by the firm. (p451, Leroy) The second term from the same text is implicit costs which is defined as expens-es that managers do not have to pay out of pocket. (p451, Leroy)

Both economic and accounting profits have their place in the analysis of the firm's activities. " Profitability is a term of economic efficiency. Mathematically, it is relative index- a fraction with profit as the numerator and generating profit flows or assets as denominator." (3) A closer look at accounting profits shows that it is mainly a mathematical process following firm's cash flow. The ex-plicit cost are explained as the expenses that a firm must incur when operating. These expenses in-clude cost of raw material, wages, capital investments in machinery and property, office supplies, and other items that must be paid cash for. The reporting of explicit costs is required to finalize the formula for ac-counting profit. Cash flow is determined by revenue generating activities that offset the expenses of explicit costs to create the activities.

For example, a business selling shoes will have explicit costs from buying the goods and running a business site. The shoes are bought from a wholesale distribu-tor and sold at a retail price. The revenue is generated from the sales of the shoes. The net profit for the shoe store (firm) would be the retail price minus the wholesale price (revenue minus explicit costs). The net profit from the sale of goods is used to pay the business expenses such as rent, utilities, wages, and insurance which reapplies the accounting equation after the net profit is determined.

The whole story is not being told when looking at the accounting profit. The implicit costs of the eco-nomic profit equation take into consideration the opportunity costs that cannot be reported in the ac-counting equation. Looking at the first part of the above quote, “ profitability is a term of economic efficiency.” the concern with implicit costs comes into consideration. The opportunity costs are the activities that the shoe sales man would be otherwise doing if not running a shoe store. What would have the shoe sales man have done if he wasn’t selling shoes? What kind of income would he had made if he was doing something else?

Let’s say, he was adoctorwho got burnt out from a high patient load and went back to work at hisfamilybusiness. As a doctor he could make $10, 000 a week and as a shoes sales man, he makes a store profit of $4000 a week.

The economic profit margin would be a -$6, 000. 00 using the equation: economic profit = revenue- explicit costs and implicit costs. The doctor/ shoes sales man must con-sider the economic profit as to how long he wants to continue in the shoe business. The outside fac-tors that an accounting profit cannot look at are affecting the value of the economic profit. The deci-sion to continue as a shoes sales man will be based on factors that are outside the explicit costs of running a firm.

When it comes to business decisions, there are many ways to analysis the profit status of a firm) business). The guidelines for the accounting profit follow an equation that recognizes profit = reve-nue minus explicit costs as a mathematical formula for cash flow management. The guideline for economic profit add the implicit costs to the equation so that non cash flow concerns can be consid-ered. With the equation, economic profit = revenue minus explicit costs and implicit costs, there is an external influence of potential revenue generating activities that represent the implicit costs (oppor-tunity costs.) The main difference between accounting profit and economic profit is the use of im-plicit costs in the economic profit equation. The ability to step back from a business and consider the impact of other activities will give a better review of whether to continue the firm's activity or not when examining the profits of a firm.

Bibliography

Author's Note:

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