An Introduction to Microeconomics
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Lecture – 89
Economic Terminology: Economic Profit and Accounting Profit

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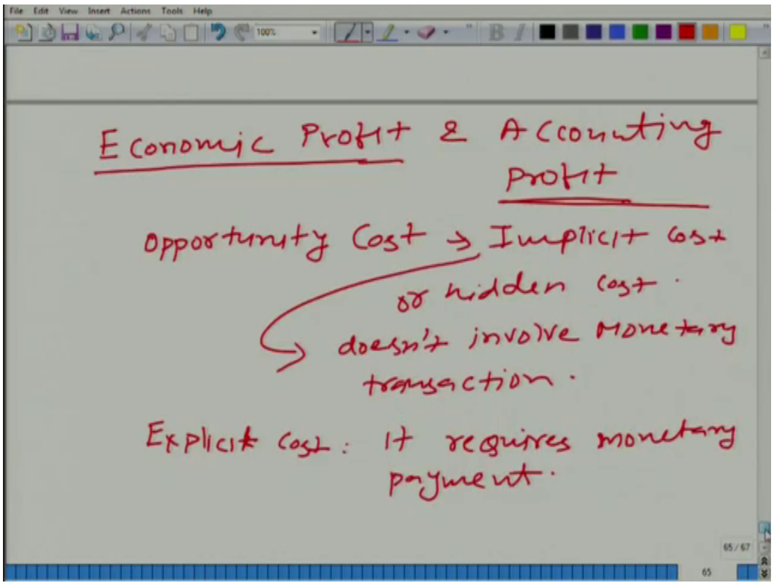

The second concept that we are going to talk about is the economic profit business profit and accounting profit. Similar when I was talking about opportunity cost, it is kind of an implicit cost or hidden cost is not it.

Student: Yes sir.

It is not very clear ok. So, one way to say what is implicit cost the cost that does not involve monetary transaction and second let us talk about explicit cost. It requires monetary payment that is clear.

Now you can talk about economic profit as well as accounting profit. Let us say that you have after graduating from this institute, you decide to start a business and let us say you are from just for example, that you are from Kanpur and you own a big a house here and you decide to operate this business from your own house.

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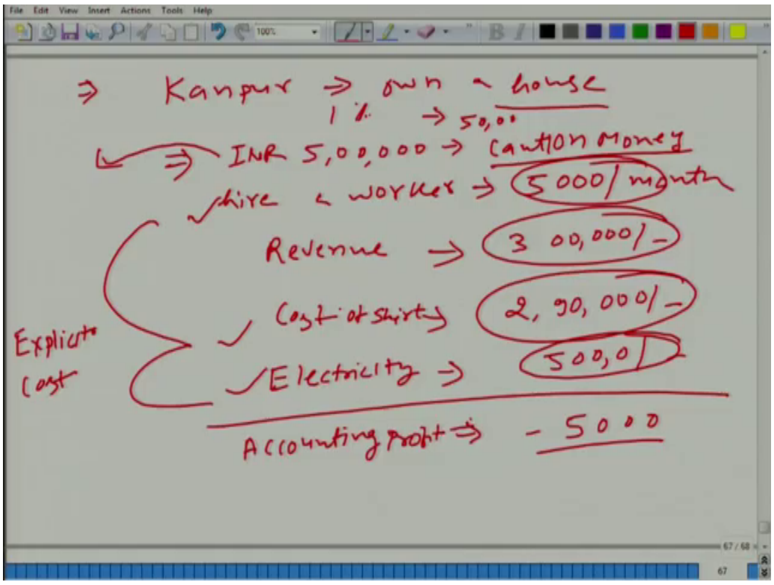

Let us say to run this business run this business, you invest your 5 lakh rupees you invest your 5 lakh rupees and you also hire a worker fine you hire a worker and you pay total let us say 5000 rupees per month to that worker ok. Fine and you need to let us say let us make a business you know you have you sell cloths.

Let us say your total revenue is your total revenue is 3 lakh rupees and the cost is that you bought 2 lakh rupees worth of or rather. So, it is the first month of operation. So, do not worry about it or you can make it 5 crore to look it really nice and it is revenue is 3 crore and;

Student: 3 crore is a;

It is not 30 lakhs. So, let us keep it sorry let us keep it at that level [FL] fine and cost of this cloth is 290,000 rupees, fine.

Student: Sir where has he invested then in hiring a worker [FL].

No, he has hiring.

Student: Common.

Student: [FL],

This he has used this he has used as cost and money that he has to pay to operate.

Fine and let us say the cost of electricity that is 5000 rupees how much do you think is his profit?

Student: Rupees 5 lakhs; 5 lakh; 5000.

5000.

Student: [FL] loss.

How much is his profit let me ask you how much is?

Student: Thus 0 0 minus 5 is he is making a loss of 5 lakhs 5000.

No 5 lakh is the caution money that he would get back.

Student: Ok.

That he would get back.

Student: Ok so.

Caution money typically you get.

Student: He is making no profit.

The operation.

Student: He is making no profit.

So, this is not a sunk cost.

Student: Sir, electricity [FL].

Electricity 5000 [FL] sorry 5000 [FL] it cannot be of 5 lakhs 5000 per month.

Student: Sir 0.

0.

Student: 10,000.

10,000.

Student: Revenue minus cost.

Revenue minus this is the cost of.

Student: Sorry it would be 000.

It is 0. So, what you are doing basically is, that you are looking at revenue and you are looking at the total cost total cost is 290,000 rupees plus 5000 and plus 5000.

By the way these look at these cost these costs are explicit cost.

Student: Explicit costs.

So, and this is what you enter in the your account book. So, your this is your accounting profit, it is 0.

But what we are missing is, some of the implicit costs what are those implicit costs.

Student: So, this man.

Typically this also is taken care in the accounting book.

That this is 5 lakh and you would earn let us say of course, you will have to make an assumption, you will earn typically let us say 10 percent then how much is the cost? Not 10, 1 percent monthly let us say 1 percent monthly then it is 5000.

Student: 5000.

Then you are making accounting profit of.

Student: 5000.

Minus 5000.

Student: Sir we are earning on that caution money or we are loosing.

We are not earning on the caution money we are losing.

Student: Ok loosing.

You are losing you could have put this money in the bank that is the;

Student: Opportunity [FL].

Opportunity cost. So, business would take care of it.

So, the; this is minus 5000 rupees is it clear.

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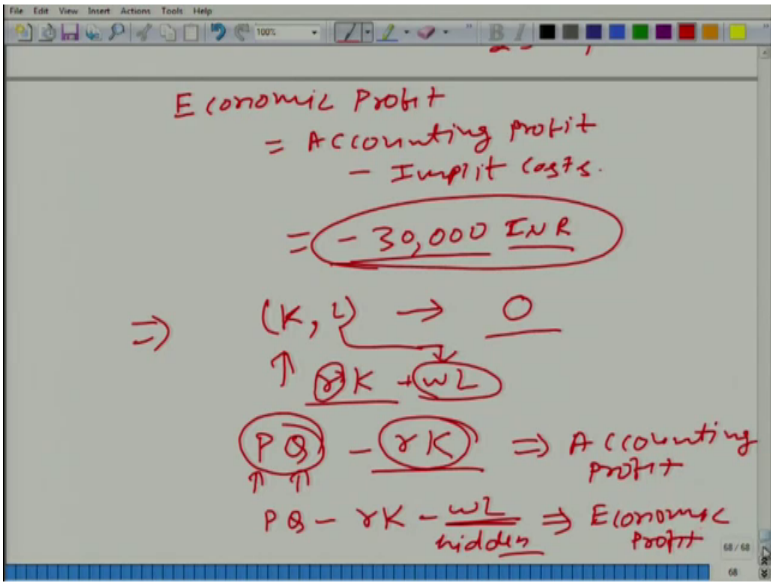

But how about economic profit? What we do we take accounting profit and we subtract.

Student: Opportunity cost.

Implicit costs and what are the implicit costs?

Student: Opportunity cost.

Opportunity cost because you are I assume here that you are running the show ok. You could have earned let us say if you had taken one of the job that placement office offered you, you could have earned some money in per month term.

That you are foregoing. So, when we calculate the economic let us say you could have earned 25000 rupees per month. So, now, economic profit here in this case is.

Student: 30,000.

Minus 30,000 rupees.

Student: And sir, even their interest on that cost of shirt shirts.

For that here we are assuming that there is no interest or anything in that case

Student: No, no, 290,000 I have put in the bank also, no, if I had that money.

But here you are you are already earning the revenue here see what you are assuming is that I understand your question, just to clarify what you are assuming that you have paid 290,000 rupees to get the shirt and then you are selling it that is what you are assuming. To keep it simple you say that you do not need to pay anything for the you know in the beginning of month to get the shirts towards end of the month once you realize your revenue you mean let us say there is a new realization and payment for the shirt both are taking at the taking place at the same time just to keep it simple, but if it is so, happening that in the beginning you have to pay for the shirt typically that is what I am talking about is the common practice.

Fine. So, in that case, you will have to include the interest that could have been that could what you could have earned on this payment, but typically let us say here we are assuming that you are not spending, and that would be your economic profit.

Here in this case it is minus 30,000 ok.

So, what we are saying just for example, like let us take a mom and pop shop and a person is selling and he has his accounting profit is 10,000 rupees after paying for the worker, after paying for the all the raw material and all the inputs what we also need to consider that, what he could have earned if he had worked outside his business.

And that is the payment for that particular person that also needs to be taken out. Typically in accounting book that is not mentioned; you understand the difference between economic profit and accounting profit. So, when we say that there is no economic profit what we mean is that, after we take care of the opportunity cost and all nothing more is left right. Just let us take an example, here we have a firm capital is rented from outside and labour is provided by the owner.

And when we say this venture is turning to out to be 0 economic profit, then the first question that people ask that then why he is working in his song. So, how did we calculate?

Student: Because shirt.

What are the cost? The cost is r multiplied by k that is the rent.

Student: Rent

On the capital and also ways that he would pay to himself.

When we talk about accounting profit what we are doing? We are calculating P multiplied by Q that is P is.

Student: Price.

Price Q is the quantity P Q is the total revenue minus r multiplied by K.

That is the payment for the capital and this is typically.

Student: Accounting.

Accounting profit.

But this is not economic profit what is economic profit P Q minus r K minus.

Student: Minus w L.

W L this is implicit this is hidden he is not being himself and then this you will get as economic profit is it clear.

Student: Yes sir.

Very very clear, the next we are going to talk about is cost versus.

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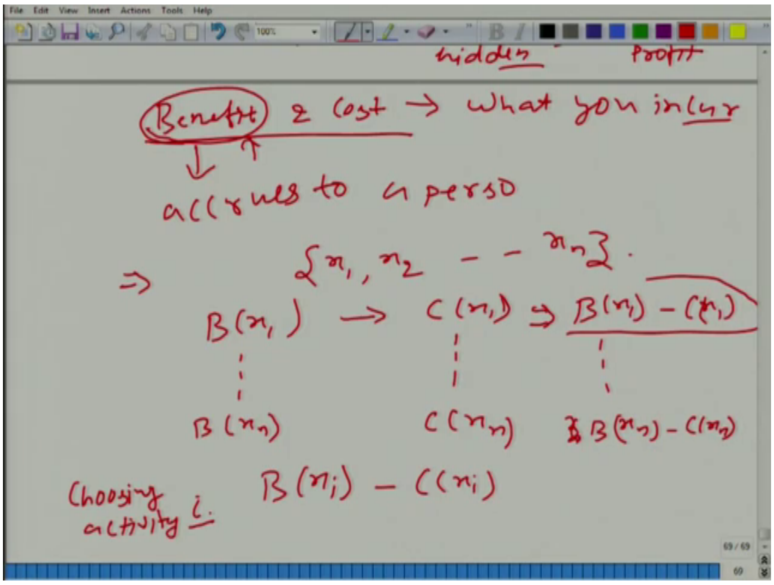

Benefit and cost here as he was saying what we do? We keep this benefit this is that accrues to a person.

And cost is what you incur and typically this benefit has nothing to do with the cost , but what we are precluding is a scenario where let us say your utility function depends on the how much money you have paid for that particular good. In that case these 2 are not independent, what we say that you get pleasure because you consume a particular good not because how much you have paid for it, in that case we keep benefit and cost separately, fine.

So, what we have to do is, whenever we decide let us say we have a bunch of activities let us say x 1, x 2 there are n activities you can do, which activity will you pick what you need to do basically is, to figure out benefit for each of these activities B x 1 to B x n and what you need to know is the corresponding costs. Again in economics we always talk about we always consider the opportunity cost.

Student: Opportunity cost.

Always it is the opportunity cost that we talk about not the accounting cost, and then what we need to do is, we need to figure out B x 1 minus C x 1 and so on and which activity will you pick the activity?

Student: Which has B x n minus C x n.

Which has highest value of.

Student: B x 1.

B x minus C x i.

Student: C x i

And once you pick the activity, what would be your opportunity cost|?

Student: The.

Or picking this activity?

Student: The because the value.

Because now you do not have just 2 options, you have more than 2 options. So, which what would be your opportunity cost of choosing activity i .

Student: the summation of all the other [FL] the value of the second maximum.

The value of the second maximum because you cannot do all other at the same time; so, it is the cost of best alternative forgone. So, you have to figure out the second most.

Student: Beneficial.

Second most beneficial activity in the net term and the value associated value, that you would have gained if you have participated in that activity would be your;

Student: Opportunity cost.

Opportunity cost.