

Accounting Profit

by Sophia



WHAT'S COVERED

This tutorial will cover how to calculate accounting profit, through the definition and discussion of total revenue and total cost.

Our discussion breaks down as follows:

1. Accounting Profit
2. Calculating Accounting Profit

1. Accounting Profit

Let's begin by getting in the mindset of a business.

The point of owning a business, for most business owners, is to make a profit, which is simply revenues minus costs.

Profit = Revenues - Costs

Revenues are all the money taken in, or sales, from selling an item, while costs comprise everything it costs to get that product to market.

If a business has any money left over, then they have made a profit.

For the purposes of this tutorial, we are specifically discussing an **accounting profit**, which is total revenue minus total cost, where total cost includes only explicit costs.

Now, we know that profit is total revenue minus total cost. Total revenue--abbreviated TR--is the price of the product times the quantity sold.

Total cost is the cost per unit times the quantity.



FORMULA TO KNOW

Accounting Profit

$$\text{Profit} = TR - TC$$

where:

$$TR = \text{price} \times \text{quantity sold}$$

$$TC = \text{cost per unit} \times \text{quantity produced}$$



TERM TO KNOW

Accounting Profit

Total revenue minus total cost, where total cost includes only explicit costs

2. Calculating Accounting Profit

Let's explore this concept by looking at an example.

Sue opens a diner and wants to know if she has made an accounting profit in her first year.

She sold 15,000 meals at \$10 each.

She figures out that her overall cost per meal, after factoring in explicit costs such as food, labor, and overhead costs, etc., was \$8 per meal.

In terms of an accounting profit, again, we take total revenue minus total cost:

Total Revenue	Total Cost
$P \times Q$	$\text{Cost per Unit} \times Q$
$\$10 \times 15,000$	$\$8 \times 15,000$
\$150,000	\$120,000

This leaves Sue with an accounting profit of \$30,000.

However, we need to make a couple notes on cost per unit.

First of all, the costs can be impacted by the scale of production.

If Sue expands her business, she may enjoy some cost savings from buying in bulk, for instance.



HINT

Whenever a business can spread out those overhead costs and their average costs start to fall, this is known as economies of scale. Therefore, cost per unit can be impacted by how small or how large a business is.

Secondly, businesses do not necessarily sell everything they produce. In reality, it is actually quite rare for them to sell everything that they produce.

What if Sue had actually produced more than the 15,000 meals but not sold them all? Let's look at the changes, highlighted in green.

Total Revenue	Total Cost
$P \times Q$	Cost per Unit $\times Q$
$\$10 \times 15,000$	$\$8 \times 16,000$
$\$150,000$	$\$128,000$

Her revenue stayed the same. In fact, She sold 15,000 meals for \$10 each, so her total revenue would still be \$150,000.

However, let's assume that she produced more than the 15,000 that she sold. She produced 16,000 and had to throw 1,000 away.

She still needs to account for this on the cost side. Her cost was still \$8 per unit, but she produced 16,000 of them, which brings her total cost to \$128,000.

Notice that this cost eats into her profit. Therefore, her accounting profit is \$22,000 instead of \$30,000.



SUMMARY

Today we learned that **accounting profit** is simply total revenue minus total cost. We explored an example of **calculating accounting profit**, noting that cost per unit can be affected by scale of production, or how big or small a firm is in terms of producing. We also learned that firms often produce more than they sell.

Source: Adapted from Sophia instructor Kate Eskra.



TERMS TO KNOW

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