MANAGERIAL ECONOMICS

PROFIT

- Meaning of Profit - Profit refers to the excess revenue after paying off all the expenses incurred.

- Accounting profit v/s Economic profit

  Accounting profit is the surplus revenue generated after all the cost incurred i.e. both manufacturing and overhead expenses. It considers all the costs that are recorded in the books of accounts. Before understanding economic profit, it is important to understand the meaning of opportunity cost. Opportunity cost is the income forgone by the entrepreneur from the second best alternative use of his resources. E.g.- If entrepreneur uses his capital in his own business then he may forgoes the income he could generate by investing the same in purchase of debentures or depositing it in with joint stock company.
  Economic profit considers implicit cost.

- **Pure Profit-** It is the profit that is left over after paying out all the explicit and implicit expenses incurred in the business which means:-
  Pure Profit= Total revenue – (Explicit exp + Implicit Exp)

- **Types of profit**

  Gross Profit- When the cost of production is deducted from the total sales proceeds, the residue is called Gross Profit.
  Gross Profit = Total Receipts – Total Expenditure

  Gross profit includes :-
  a) Remuneration for the factors of production contributed by the entrepreneur himself.
  b) Depreciation and maintenance cost- Depreciation refers to the reduction in the value of assets due to its normal and tear whereas expenses incurred for personal use is consider as personal expenditure. And both are recorded in the books of accounting.
  c) Monopoly profits- The profit which is not earned by the abilities and efforts of businessman but because he is the monopolist in his field.

Net Profit- When all the above mentioned payments are deducted from Gross profit then the result will be the Net Profit.

Theories of Profits

1) Risk theory of profit- (a) Developed by American economist Hawley. According to him, Profit is the reward of risk taking. However, his theory was criticized on several grounds. Profit is the reward of risk avoiding as if we say in the context of mediocre businessman, he cannot eliminate the risk but he can avoid it to achieve the desired results.

2) Uncertainty bearing theory of profit (a) Developed by Prof. F.H Knight. (b) He classified risks under two categories :-
(i) Insurable risks- The risks which can be minimized by merely taking an insurance policy.
(ii) Uninsurable risks – The risks which cannot be insured like change in demand, increase in prices of raw material. These risks have to borne by the entrepreneur himself.

3) Innovation theory of profit- (a) Developed by Joseph Schumpeter. (b) According to him, profit is a reward of innovations. But his theory was also criticized on several grounds as he overlooked all the other factors which are considered to be important for making profits.

4) Dynamic Theory of profit- (a) Developed by Economist J.B. Clark
(b) This theory states that the world is full of dynamics such as changes in quantity and quality of human needs, their changes in tastes and preferences, changes in techniques of production, changes in market conditions. Entrepreneur who cannot adjust with the changes, always lag behind. Profit is the reward of dynamism.
This theory by Clark was also criticized as there are some changes which are not in the control of the entrepreneur such as changes in monetary policy, taxation policies, expansion and contraction in supply of capital.

Methods of Calculating Depreciation

(I) Straight Line method- Under this method, a uniform amount of depreciation is annually deducted from the price of asset. In this way, at the end of its life, firm will collect an amount equal to the value of asset and would be able to purchase a new one. Amount of Depreciation is calculated as :-

$$\text{Depreciation} = \frac{\text{Price} - \text{Scrap value}}{\text{Life of the asset}}$$

(II) Diminishing Balance Method- In this method, annual percentage of depreciation is charged but from the next year, depreciation is charged on the remaining value of asset i.e. Price of asset – Depreciation

(III) Annuity method – In this method, equal annual amount is first calculated for the entire life of an asset and charged on it in once at the end.

(IV) Service Unit Method – In this method, instead of considering life of an asset while calculating depreciation, the actual working hours can be taken.

Profit policy

(I) Profit Expectations

(a) The rate of profit should be sufficient so that more and more capital can be raised by the company which is a result of attractive rate of production

(b) Rate of production should be comparable so that company could stand in competition in market.

(c) Profit share should always be more than the past for ongoing growth.

(d) If the profits are to be invested then it should be noted that same is invested in the area which gives growth and expansion.

(II) External Factors

(a) Potential Rivals- The possibility of emergence of rival firms must be taken into consideration and to keep away the rivals, profits should be controlled.

(b) Consumers' confidence- The temptation of some entrepreneur of reaping huge profits usually loses the confidence of consumers.