Meaning and Computation of Normal Profits

Normal profit is an economic term that describes when a company's total revenues are equal to its total costs in a perfectly competitive market. NP is included in the costs of production because it is the minimum amount that justifies why the firm is still in business.

In economics, normal profit is the minimum compensation that a firm receives for operating. The compensation is higher than the opportunity cost that the firm loses for using its resources effectively and producing a given product. If a firm's profits are lower than its revenues, the firm incurs losses. It must meet a minimum threshold to stay in business.

Furthermore, because the normal profit is equal to zero, it doesn't mean that the firm is not profitable. The NP compares the effective use of the firm's resources to its revenues.

When a business is making a normal profit, its economic profit is said to be zero. Remember that the terms "normal profit" and "economic profit" convey the same meaning and can be used interchangeably.

When normal profit is zero, it doesn't mean that the firm is not making an accounting profit. Accounting profit is equal to total revenues minus total costs.

Accounting profit = Total revenues – total costs

Where,

Costs refer to explicit costs. These are represented by:

⇨ Material costs

⇨ Labor costs

⇨ other costs related to the business

⇨ Compensation payable to the owner

NOTE – this cost element of compensation payable to the owner excludes the opportunity cost of the owner not taking up any other activity.

If the opportunity cost is included in the cost calculation, the total cost required to calculate economic profit will be obtained.

The following formula will illustrate the difference between accounting profit mentioned above and normal profit:

Normal profit = 0 = Total revenues – total costs (explicit costs *and* implicit costs)

What if the normal profit is greater than zero? In that case, the firm is said to be earning a super-normal profit. However, in a competitive market, this situation cannot last very long. Other firms will enter the fray and drive prices down. As a result of this, a situation where there is normal profit will prevail once again.

Example

Karry is a financial analyst working for an esteemed securities firm. She wants to check the companies in a client's portfolio to see which one realizes a NP. Karen thinks that at least one of the companies in the portfolio should not stay in business as it incurs losses for two years in a row.

Karen creates an Excel file with the five companies that she follows in the particular portfolio, and she adds the total revenues, and fixed costs, variable costs, and opportunity costs to calculate the total costs of each firm.

Normal Profit					
	Company A	Company B	Company C	Company D	Company E
Total Revenues	235,650	245,698	260,500	285,440	269,788
Fixed Costs	45,200	35,800	39,850	41,740	38,260
Variable Costs	94,520	68,477	125,630	143,700	82,650
Opportunity Cost	100,000	100,000	100,000	100,000	100,000
Total Costs	239,720	204,277	265,480	285,440	220,910
Profit/Losses	(4,070)	41,421	(4,980)	-	48,878

Karen assumes that all firms have the same opportunity cost, equal to $100,000 million. Total revenues range between $235,650 and $285,440 as the firms compete in the same industry.

Of the five companies, company A and company C incur losses of $4,070 million and $4,980 million, respectively. Company B and company E realize a gain of $41,421 million and $48,878 million, respectively. Company D has a NP because the difference of the total revenues minus the total costs is zero