# The Concept of Profit in Accounting and Economics

In general, the term ‚profit' stands for the difference between revenue and costs. However, for one and the same activity, profit does not necessarily have to be the same number under different points of view. Different accounting standards (like US GAAP and IAS) or special regulations for taxation make organizations display different profits in financial statements for different purposes.
On top of that, profit from the accountant's point of view is not equal to profit from the economists point of view. This difference is not based in different principles on what to evaluate how, but in fundamentally different understandings of costs and profits.
This article will describe the differences of profit in accounting and economics without discussing details of cost theory.

## Approaches to Profit Maximization

Managerial accounting is a discipline of business management. The sciences of business management and economics have different approaches to profit maximization, due to their different subjects.
The subject of business management is the business activities and the development of economic procedures for achieving particular objectives in every single organization or business unit.
Economics, on contrast, deals with the characteristics of the economic relationships between all business units that are linked in an economy; hence, it looks at the total economy.
Economical data like pricing of factors, needs and demand structures, impact or technological progress on useful lifes of assets, are fixed data for every single business unit from a managerial point of view. A single organization cannot influence these data, but it has to consider them when planning and carrying out their activities. Contrary, managerial data like cost structures, organization of production, working hours etc. are fixed data for economists. They presume that production processes and the resulting cost structures cannot be changed (at least in the short term).

This results in different approaches for profit maximization:

From the managerial view, increases in profits can be achieved by measures for reducing costs or increasing revenues. These could be rationalization programs (e.g. investment in equipment with higher efficiency, reorganization of process, standardization), measures for quality improvement or marketing activities for increasing sales.
In economics, profit is maximized by increasing the volume of production and sales up to that point in which marginal costs of one additional unit produced and sold are equal to the marginal revenue generated with this additional unit. [1] Production systems and processes remain unchanged. From an economical point of view, maximal profit does not result from an optimal and cost-effective design of all organizational processes, but from production and sales at the optimal level in the existing organizational situation.

## The Scope of Costs

Generally in accounting and economics applies:

[1] Marginal costs / revenues are those costs / revenues are the additional costs / revenues that occur with every single additional unit.


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Profit = Total Revenue – Total Costs

However, the scope of the term ‚costs' is wider in economics than in accounting. Both disciplines take into account all costs the organization actually incurs. (For ease of understanding, we will neglect neutral costs that are not directly related to the operations of the organization here.)
Accounting structures costs according to their cause. It distinguishes for instance costs of material, labor, depreciation, interests and other expenses. The economist distinguishes costs as fixed and variable costs by their dependency from production volume.

The term costs in a managerial sense includes all costs that are related with the production and selling of the organizations goods and services. In the simplest model, the company's revenues less the costs that are incurred by producing and selling the goods and services sold equal profit (or loss). The owners of the company decide how to use this profit. Profits can be distributed to the owners, or they can be left in the organization to finance further investments. The partly or total distribution of profits to the owners provides them an interest return for the financial means they invested into the company. Hence, costs in a managerial sense do not include interests for the owners' investments into the company. These interests have to be paid from profit.

The economical scope of costs exceeds this managerial view. Due to the concept of opportunity costs, costs in an economical sense include an adequate interest return on the capital invested by the owners. Opportunity costs are the costs or compensation for not exploited alternative opportunities. Thus, economics take into considerations that the owners could invest their money differently than into this particular organization (e.g. bonds, funds, property etc). As a compensation for the (secure) interest returns the owners would get from these alternative investments, the economist allocates an adequate interest return on the capital invested into a company to the owners. Hence, costs in an economical sense include all those costs that are necessary to keep the company in business – including a compensation for owners so that they do not invest their money in more lucrative investments.

Whereas in business management returns to owners have to be paid from profits, the economical scope of profit already includes an adequate interest on capital invested by the owners. What is adequate is determined by lost interests the owners would have earned from investing their money elsewhere.