DOWNLOAD PDF MEASUREMENT OF PROFIT IN MANAGERIAL ECONOMICS

Chapter 1 : Economic Versus Accounting Measures of Cost and Profit - Managerial Economics [Book]

This profit concept is frequently referred to as economic profit. Measurement of Profit and Profit Policy The concepts of business profit and economic profit can be used to explain the role of profits in a free enterprise economy.

December 11, Managerial Economics of Profit - Economics for CEO - Review Notes "A business firm is an organization designed to make profits and profits are the primary measure of its success. To make profits, firms have to satisfy the desires of the buyers and other stakeholders of the society. The firm can continue as profit system only by satisfying the stakeholders. Joel Dean highlighted three issues regarding profit. Profit measurement - Economic analysis of accounting data for policy making 2. Policy decisions on profit standards and profit goals 3. Use of profits for control purposes in complex business organizations. Economic Analysis of Profits Measurement by Accoutants "Economists are unhappy about conventional accounting methods for measuring business income. For decision making today past is irrelevant, excepting for its use in forecasting for the future. Joel Dean discussed four issues specially. The types of costs to be deducted from revenues to arrive at profit. The treatment of capital gains and losses 4. Price level basis of valuation of assets. Policy decisions on profit standards and profit goals Reasons for Limiting Profits it is an interesting topic and Joel Dean brought into explanation at the start of the topic. To discourage potential competitors. To woo the voting public and restrain the zeal of antitrusters. To restrain wage demands of organized labor. To maintain customer good will 5. To keep control undiluted. To maintain pleasant working cnditions. Joel Dean highlighted the need for restraining profits and gave some guidelines for determining reasonable profits. Profits for Control 1. In divisional organization, where products are different: In vertically integrated organization There is complexity in this issue, and the conclusion is that profit standard for control must be set largely by managerial ukase, designed with discretion and wisdom.

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Chapter 2 : Managerial Economics Overview

The concept of profit entails several different meanings. Profit may mean the compensation received by a firm for its managerial function. It is called normal profit which is a minimum sum essential to induce the firm to remain in business.

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Chapter 3 : Profit Maximization Methods in Managerial Economics

MEASUREMENT OF BUSINESS PROFIT RATES in Managerial Economics - MEASUREMENT OF BUSINESS PROFIT RATES in Managerial Economics courses with reference manuals and.

Practice Test In long-run equilibrium, profits in perfectly competitive industries are usually just sufficient to provide a normal risk-adjusted rate of return. In monopoly markets, barriers to entry or exit can allow above-normal profits, even over the long run. Nevertheless, high profits are sometimes observed in vigorously competitive markets, while some monopolies stumble from one year to the next without realizing superior rates of return. To appreciate the sources of profit differences, it is first necessary to understand conventional measures of business profits. As seen in Table, ROE can also be described as the product of three common accounting ratios. When profit margins are high, robust demand or stringent cost controls, or both, allow the firm c xto earn a significant profit contribution. Table shows the outstanding profit margins reported by smokeless tobacco producer UST, Inc. Despite high profit margins, firms in mining, construction, heavy equipment manufacturing, cable TV, and motion picture production often earn only modest rates of return because significant capital expenditures are required before meaningful sales revenues can be generated. Thus, it is vitally important to consider the magnitude of capital requirements when interpreting the size of profit margins for a firm or an industry. Total asset turnover is sales revenue divided by the book value of total assets. When total asset turnover is high, the firm makes its investments work hard in the sense of generating a large amount of sales volume. For example, consider environmental services juggernaut Waste Management, Inc. Despite modest profit margins and a conservative financial structure, Waste Management reports a sterling ROE by virtue of the fact that it reports a total asset turnover rate that is well in excess of industry and corporate norms. Waste Management has learned that the wise use of assets is a key ingredient of success in the often cutthroat environmental services business. It reflects the extent to which debt and preferred stock are used in addition to common stock financing. Leverage is used to amplify firm profit rates over the business cycle. Despite ordinary profit margins and modest rates total asset turnover, ROE in the securities brokerage, hotel, and gaming industries can sometimes benefit through use of a risky financial strategy that employs significant leverage. However, it is worth remembering that a risky financial structure can lead to awe-inspiring profit rates during economic expansions, such as that experienced during the late s; it can also lead to huge losses during economic downturns, such as that in This average ROE is comprised of a typical profit margin on sales revenue of roughly 4 percent, a standard total asset turnover ratio of 1. ROE is an attractive measure of firm performance because it shows the rate of profit earned on funds committed to the enterprise by its owners, the stockholders. When ROE is at or above 12 percent per year, the rate of profit is generally sufficient to compensate investors for the risk involved with a typical business enterprise. When ROE consistently falls far below 12 percent per year, profit rates are generally insufficient to compensate investors for the risks undertaken. Of course, when business risk is substantially higher than average, a commensurately higher rate of return is required. When business risk is somewhat lower than average, a somewhat lower than average profit rate is adequate. This naturally suggests an important question: How is it possible to know if business profit rates in any given circumstance are sufficient to compensate investors for the risks undertaken? The answer to this difficult question turns out to be rather simple: If performance is above the minimum required, bank financing is easy to obtain; if performance is below the minimum required, bank financing is difficult or impossible to procure. As a practical matter, firms must consistently earn a business profit rate or ROE of at least 12 percent per year in order to grow and prosper. If ROE consistently falls below this level, sources of financing tend to dry up and the firm withers and dies. If ROE consistently exceeds this level, new debt and equity financing are easy to obtain, and growth by new and established competitors is rapid. Although ROE is perhaps the most useful available indicator of business profits, other accounting measures can also be used to compare profit rates across different lines of business. The accounting return on assets ROA , defined as net income divided by total assets, is also a useful indicator of the business profit rate. Therefore, although ROAis a useful alternative indicator of the basic profitability of a business, it fails to account for the effects of financial leverage decisions on firm performance. Irrespective of whether ROE, ROA, or some other measure of business profits is employed, consistency requires that comparisons be made using a common basis.

Chapter 4 : 7 Important Scopes of Managerial Economics

Managerial Economics of Profit - Economics for CEO - Review Notes "A business firm is an organization designed to make profits and profits are the primary measure of its success." Joel Dean.

Demand analysis and forecasting. Cost and production analysis. Pricing decisions, policies and practice. Analysis of business environment. Now we discuss these in detail: A business firm is an economic organization which is engaged in transforming productive resources into goods that are to be sold in the market. A major part of managerial decision-making depends on accurate estimates of demand. A forecast of future sales serves as a guide to management for preparing production schedules and employing resources. It will help management to maintain or strengthen its market position and profit-base. Demand analysis also identifies a number of other factors influencing the demand for a product. Demand analysis and forecasting occupies a strategic place in Managerial Economics. Cost estimates arc most useful for management decisions. The different factors that cause variations in cost estimates should be given due consideration for planning purposes. There is the clement of uncertainty of cost as other factors influencing cost arc either uncontrollable or not always known. If one is able to measure cost it is very important for more sound profit planning, cost control and often for sound pricing practices. Pricing practices and policies: As price gives income to the firm, it constitutes as the most important field of Managerial Economics. The success of a business firm depends very much on the correctness of the price decisions taken by it. The various aspects that are dealt under it cover the price determination in various market forms, pricing policies, pricing method, differential pricing, productive pricing and price forecasting. The chief purpose of a business firm is to earn the maximum profit. There is always an element of uncertainty about profits because of variation in costs and revenues. If knowledge about the future were perfect, profit analysis would have been very easy task. But in this world of uncertainty expectations are not always realized. Hence profit planning and its measurement constitute the most difficult area of Managerial Economics. Under profit management we study nature and management of profit, profit policies and techniques of profit planning like Break Even Analysis. Capital management implies planning and control of capital expenditure because it involves a large sum and moreover the problems in disposing the capital assets of arc so complex that they require considerable time and labour. The main topics dealt with under capital management arc cost of capital, rate of return and selection of projects. The topics discussed under headings from 1 to 5 are related with operational issues of a firm. Analysis of business environment: The environmental factors influence the working and performance of a business undertaking. Therefore, the managers will have to consider the environmental factors in the process of decision-making. Decisions taken in isolation of environmental factors would prove harmful to the firm. Therefore, the management must be fully aware of economic environment, particularly those economic factors which constitute the business climate. Nevertheless, the management must have an idea of social and political trends. Also the main factors that affect the business climate are: Certain macro-economic theories such as income and employment theory, monetary theory etc. Analysis of monetary policy, fiscal policy, industrial policy, foreign trade policy and other direct controls also help in forecasting business climate. Therefore, macro-economic theory and government policies arc also included in the scope of managerial economics. The concepts that help the management in taking business decision are quantitative in nature. Therefore, mathematical tools are widely used in determining relationships between economic variables. The linear programming techniques, which is mathematical, is used by firms to maximize or minimize their objective function. Similarly statistical and accounting principles are used in taking business decision. Therefore, mathematical tools, statistical technique and accounting principles that are used in analyzing business problems also come under the scope of Managerial Economics.

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Chapter 5 : Top 5 Theories of Profit â€“ Explained!

Firms with higher managerial skills and production efficiency are required to be compensated by above-normal profits (i.e. economic profits). Therefore, this theory is also called compensatory theory of profits.

Helpful in Profit Planning and Control Managerial economics helps managers to decide on the planning and control of the benefits. Managerial Economics is synchronized between the planning and control of any institution or firm and hence its importance increases. Thus, It plays a huge role in business decisions. Definition, Nature, Scope Notes 8. Helpful for Business Prediction It is not known to anyone about what is going on in business. So Then the managerial economics gives its solutions. So that they can be avoided and the benefits can be increased. Helpful in Price Determination Managerial Economics provides the necessary guidance in managing the pricing of its business. This proves this in order to raise the required data in pricing and get the maximum benefit. So That is the major role of managerial economics in the business decision critical. Without this, no business can progress. Sectional Balancing System Practical Examples. Helpful in Solutions of Business Taxation Problems Managerial Economics provides useful guidance in solving problems caused by various types of tax done in business. And contracting of business helps reduce problems. To maximize profit at low cost and minimize business costs. Health Tips Organic Food: From which business decisions get help. The entire economy is very complex but business economics solves it with ease. But Managerial Economics exploits this easily and benefits the business. Attempt to put out the friendly business Managerial Economics guides managers to adjust to suit the external conditions of the business. It may be the type of external environment. Supporting the Manufacture and use of Models Managerial Economics creates an economic model for managers to inspire their use in business. In order to maximize production and maximum profit, at least cost can be paved. Thus, Business economics only tells how to manage everything in a way that everything should be corrected in order to maximize profits. Business economics has a very important role and role in doing all this work in business decisions. Useful in showing the path of Economic well-being Managerial Economics inspires managers to operate the business in such a way that the path of maximum economic welfare is paved. Gives the Right Direction Inside the business, managerial economics has a very big role because it handles that business. Shows the right path to every member of the business, and also gives the right direction of what his duty and job. Maintains of Costs It is the job of managerial economics to say how much to spend in business and how to spend those expenses so that it can get more profit at lower costs and increase business growth. Distribute Profit Inside any business, managerial economics tells us how to distribute the profits and invest in where to make the business more profitable in the coming time and more growth in the business field. Measurement of the Efficiency of the Firm Managerial Economics provides useful tools for managers in measuring the efficiency of the business firm. Managerial Economics plays big salient features and significance of managerial economics In Choosing Right Decisions in helping business in many ways. Business planning and profit maximization and economic well-being.

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Chapter 6 : Introduction to Managerial Economics

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Scope of Managerial Economics Managerial economics has emerged as a new branch of knowledge and Managerial economics is currently undergoing development. Therefore, there was not much known about its area, but I am going to explain the areas which are usually seen. Which prove to be very helpful to you. Production and Cost Analysis Managerial economics determines the quantity of production and analyzing. Thus, under the assumptions of cost-average marginal cost expansion and variable costs, 2. The elasticity of demand and interpretation of income-effect, 3. Replacement effects and price impact, 4. Along with economic theory and psychological perception and 5. External circumstances, the effect of demand is taken care. Price Policies and Practices Pricing is a matter of paramount importance for any firm. Full competition , 2. Incomplete competition , 3. One right, non-negotiable and 4. Therefore, It also involves short-term and long-term pricing policies. Thus, Useful in showing the path of economic well-being- Business economics inspires managers to operate the business in such a way that the path of maximum economic welfare is paved. Profit Maximization or Profit Management The purpose of each producer and the business firm is to maximize profit. The amount of profit depends on the cost and cost. Thus, the managerial economics 1. The benefits of maximization and profit planning for the benefits, 2. The nature of the assumptions and benefits, 3. The measurement of profit 4. The appropriate benefits policy comes into the ordered zone. Capital Management Capital is the life of the modern business. Thus, the evaluation of the discretion for the full election from the alternative expenditure of capital. The sources of capital known by the managers are used in the way of using those sources in the right way, and the firm is given the most benefit. This is all described in this area. Project Evolution When business projects are evaluated, the utility and poets of different schemes of business are traced. So that those deficiencies and utilities should be adjusted and used by making new rules. Others Which does not come into the study area of managerial economics? So is considered in the periphery of the field of managerial economics, which is as follows. Industry and Trade Policies of Govt. The government changes its business policies whether the central government, state govt. Study of business cycles , 2. General value level, 6. The method of cost control and method of maximizing profit. Managerial economics has emerged as a new branch of knowledge and Managerial economics is currently undergoing development. Therefore, there was not much known for its area. Conclusion Thus, The areas of managerial economics are now going through a developing phase and many of these students are there. Those who are still hidden from us. But the managerial economics influence many facts of the profession and provide help in their development. Management Economics teaches us that any business is required to make proper management to move forward.

Chapter 7 : Scope of Managerial Economics - Economics l Concepts l Topics l Definitions l online

Inside any business, managerial economics tells us how to distribute the profits and invest in where to make the business more profitable in the coming time and more growth in the business field. Measurement of the Efficiency of the Firm.

Next Page A close interrelationship between management and economics had led to the development of managerial economics. Economic analysis is required for various concepts such as demand, profit, cost, and competition. Managerial economics is a discipline that combines economic theory with managerial practice. It helps in covering the gap between the problems of logic and the problems of policy. The subject offers powerful tools and techniques for managerial policy making. Macroeconomics deals with the performance, structure, and behavior of an economy as a whole. Managerial economics applies microeconomic theories and techniques to management decisions. It is more limited in scope as compared to microeconomics. Macroeconomists study aggregate indicators such as GDP, unemployment rates to understand the functions of the whole economy. Microeconomics and managerial economics both encourage the use of quantitative methods to analyze economic data. Businesses have finite human and financial resources; managerial economic principles can aid management decisions in allocating these resources efficiently. Macroeconomics models and their estimates are used by the government to assist in the development of economic policy. Nature and Scope of Managerial Economics The most important function in managerial economics is decision-making. It involves the complete course of selecting the most suitable action from two or more alternatives. The primary function is to make the most profitable use of resources which are limited such as labor, capital, land etc. A manager is very careful while taking decisions as the future is uncertain; he ensures that the best possible plans are made in the most effective manner to achieve the desired objective which is profit maximization. Economic theory and economic analysis are used to solve the problems of managerial economics. Economics basically comprises of two main divisions namely Micro economics and Macro economics. Managerial economics covers both macroeconomics as well as microeconomics, as both are equally important for decision making and business analysis. Macroeconomics deals with the study of entire economy. It considers all the factors such as government policies, business cycles, national income, etc. Microeconomics includes the analysis of small individual units of economy such as individual firms, individual industry, or a single individual consumer. All the economic theories, tools, and concepts are covered under the scope of managerial economics to analyze the business environment. The scope of managerial economics is a continual process, as it is a developing science. Demand analysis and forecasting, profit management, and capital management are also considered under the scope of managerial economics. Demand Analysis and Forecasting Demand analysis and forecasting involves huge amount of decision-making! Demand estimation is an integral part of decision making, an assessment of future sales helps in strengthening the market position and maximizing profit. In managerial economics, demand analysis and forecasting holds a very important place. Profit Management Success of a firm depends on its primary measure and that is profit. Firms are operated to earn long term profit which is generally the reward for risk taking. Appropriate planning and measuring profit is the most important and challenging area of managerial economics. Capital Management Capital management involves planning and controlling of expenses. There are many problems related to capital investments which involve considerable amount of time and labor. Cost of capital and rate of return are important factors of capital management. Demand for Managerial Economics The demand for this subject has increased post liberalization and globalization period primarily because of increasing use of economic logic, concepts, tools and theories in the decision making process of large multinationals. Also, this can be attributed to increasing demand for professionally trained management personnel, who can leverage limited resources available to them and maximize returns with efficiency and effectiveness. Role in Managerial Decision Making Managerial economics leverages economic concepts and decision science techniques to solve managerial problems. It provides optimal solutions to managerial decision making issues.

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Chapter 8 : Economic Versus Accounting Measures of Cost and Profit

Hence profit planning and its measurement constitute the most difficult area of Managerial Economics. Under profit management we study nature and management of profit, profit policies and techniques of profit planning like Break Even Analysis.

Read this article to get information on Managerial Economics: Economic Theory and Managerial Theory 4. Nature of Managerial Economics 5. Scope of Marginal Economics 6. Subject Matter of Marginal Economics 7. Relation to Other Branches of Knowledge 8. Techniques or Methods of Marginal Economics 9. Role of Managerial Economics in Business Development Role and Responsibility of a Managerial Economist Responsibilities of a Managerial Economist! The science of Managerial Economics has emerged only recently. With the growing variability and unpredictability of the business environment, business managers have become increasingly concerned with finding rational and ways of adjusting to an exploiting environmental change. The problems of the business world attracted the attentions of the academicians from onwards. In simple terms, managerial economics means the application of economic theory to the problem of management. Managerial economics may be viewed as economics applied to problem solving at the level of the firm. It enables the business executive to assume and analyse things. Every firm tries to get satisfactory profit even though economics emphasises maximizing of profit. This function is being done by managerial economics. Managerial economists have defined managerial economics in a variety of ways: To Christopher Savage and John R. Economic Theory and Managerial Theory: Economic Theory is a system of inter-relationships. Among the social sciences, economics is the most advanced in terms of theoretical orientations. One of the most widely discussed structures is the postulational or axiomatic method of theory formulation. It insists that there is a logical core of theory consisting of postulates and their predictions which forms the basis of economic reasoning and analysis. This logical core of theory cannot easily be detached from the empirical part of the theory. The theory of competitive equilibrium is entirely based on axiomatic method. Both in deductive inferences and inductive generalisations, the underlying principle is the interrelationships. Managerial theory refers to those aspects of economic theory and application which are directly relevant to the practice of management and the decision making process. It is concerned with those analytical tools which are useful in improving decision making. The managerial theory provides the maximum help to a business manager in his decision making and business planning. The managerial theoretical concepts and techniques are basic to the entire gamut of managerial theory. Economic theory deals with the body of principles. Economic theory has the characteristics of both micro and macro economics. But managerial theory has only micro characteristics. Economic theory deals with a study of individual firm as well as individual consumer. Economic theory deals with a study of distribution theories of rent, wages, interest and profits. But managerial theory deals with a study of only profit theories. Economic theory is based on certain assumptions. But in managerial theory these assumptions disappear due to practical situations. Economic theory is both positive and normative in character but managerial theory is essentially normative in nature. Economic theory studies only economic aspect of the problem whereas managerial theory studies both economic and non-economic aspects. Nature of Managerial Economics: Managerial economics is a science applied to decision making. It bridges the gap between abstract theory and managerial practice. It concentrates more on the method of reasoning. Managerial economics is supposed to enrich the conceptual and technical skill of a manager. It is concerned with economic behaviour of the firm. It concentrates on the decision process, decision model and decision variables at the firm level. It is the application of economic analysis to evaluate business decisions. The primary function of a manager in business organisation is decision making and forward planning under uncertain business conditions. Some of the important management decisions are production decision, inventory decision, cost decision, marketing decision, financial decision, personnel decision and miscellaneous decisions. One of the hallmarks of a good executive is the ability to take quick decision. He must have the clarity of goals, use all the information he can get, weigh pros and cons and make fast decisions. The decisions are taken to achieve certain objectives. Objectives are the motivating factors in taking decision. Several acts are performed to attain the objectives quantitative techniques are also used in decision making. But it may be noted that acts and quantitative techniques alone will not produce desirable results. Scope of Marginal Economics: Managerial Economics is a developing subject. The scope of managerial economics refers to its area of study. Managerial economics has its roots in economic theory. While considering the scope of managerial economics we have to understand whether it is positive economics or normative economics. Positive versus Normative Economics: Most of the managerial economists are of the opinion that managerial economics is fundamentally normative and prescriptive in nature. It is concerned with what decisions ought to be made. In managerial economics, we are interested in what should happen rather than what does happen. Instead of explaining what a firm is doing, we explain what it should do to make its decision effective. Robbins regards economics as a pure science of what is, which is not concerned with moral or ethical questions. Economics is neutral between ends. The economist has no right to pass judgment on the wisdom or folly of the ends itself. He is simply concerned with the problem of resources in relation to the ends desired. The manufacture and sale of cigarettes and wine may be injurious to health and therefore morally unjustifiable, but the economist has no right to pass judgment on these since both satisfy human wants and involve economic activity. Normative economics is concerned with describing what should be the things. It is, therefore, also called prescriptive economics. What price for a product should be fixed, what wage should be paid, how income should be distributed and so on, fall within the purview of normative economics? It should be noted that normative economics involves value judgments. It refers mostly to what ought to be and cannot be neutral about the ends. The application of managerial economics is inseparable from consideration of values, or norms for it is always concerned with the achievement of objectives or the optimisation of goals. Managerial economists are generally preoccupied with the optimum allocation of scarce resources among competing ends with a view to obtaining the maximum benefit according to predetermined criteria. To achieve these objectives they do not assume ceteris paribus, but try to introduce policies. The very important aspect of managerial economics is that it tries to find out the cause and effect relationship by factual study and logical reasoning. The scope of managerial economics is so wide that it embraces almost all the problems and areas of the manager and the firm. Subject Matter of Marginal Economics: A firm is an economic organisation which transforms inputs into output that is to be sold in a market. A major part of managerial decision making depends on accurate estimates of demand. When demand is estimated, the manager does not stop at the stage of assessing the current demand but estimates future demand as well. This is what is meant by demand forecasting. This forecast can also serve as a guide to management for maintaining or strengthening market position and enlarging profit. The main topics covered are: Cost analysis is yet another function of managerial economics. In decision making, cost estimates are very essential. The factors causing variation in costs must be recognised and allowed for if management is to arrive at cost estimates which are significant for planning purposes. The determinants of estimating costs, the relationship between cost and output, the forecast of cost and profit are very vital to a firm. An element of cost uncertainty exists because all the factors determining costs are not always known or controllable. Managerial economics touches these aspects of cost analysis as an effective knowledge and the application of which is corner stone for the success of a firm. Production analysis frequently proceeds in physical terms. The factors of production otherwise called inputs, may be combined in a particular way to yield the maximum output. The main topics covered under cost and production analysis are production function, least cost combination of factor inputs, factor productiveness, returns to scale, cost concepts and classification, cost-output relationship and linear programming.

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Chapter 9 : Profit: Concept, Policies, Measurement, Planning and Controlling

Managerial economics is a discipline that combines economic theory with managerial practice. It helps in covering the gap between the problems of logic and the problems of policy. The subject offers powerful tools and techniques for managerial policy making.

Top 5 Theories of Profit â€" Explained! Article Shared by The following theories are briefly discussed below: Frictional Theory of Profits: According to this theory there exists a normal rate of profit which is a return on capital that must be paid to the owners of capital as a reward for saving and investment of their funds rather than to consume all their income or hoard them. In a static economy where no unanticipated changes in demand or cost conditions occur, in long-run equilibrium the firms would be earning only normal rate of profit on their capital and entrepreneurial talent. Under these conditions economic profits would not accrue to the firms. Frictional theory of profit explains that shocks or disturbances occasionally occur in an economy as a result of unanticepated changes in product demand or cost conditions which cause disequilibruim conditions. It is these disequilibrium conditions that brings into existence positive or negative economic profits for some firms. Thus, according to frictional theory, economic profits exist for some time because of frictional factors which prevent an instanteous adjustment of the system to the new conditions. For example, at the time of sharp size in petroleum prices in the as a result of US-Iraq war many petroleum-refining firms enjoyed handsome economic profits. Similarly, as a result of slowdown in world trade in the years many Indian firms doing export business suffered losses due to the decrease in the demand for their products in the USA and other countries. When economic profits are made in the short run, more firms will enter the industry in the long run until all economic profits are driven down to zero that is, firms will be making only normal return or profits on their capital investment. On the other hand, when firms are making losses i. This will cause price of the product to rise so that losses are eliminated and the remaining firms make only normal profits. Stigler, a winner of Nobel Prize in economics sums up the frictional theory of profits in the following words: If prices are higher, or costs lower than were anticipated, entrepreneurs will receive a return in excess of the alternative product of their resources. If prices were lower or costs higher than were anticipated, entrepreneurs will receive less than the alternative product of their resources i. Positive profits may persist for a long time if firms outside the industry are show to enter the industry and negative profits can persist as long as specialised equipment yields more when used in the industry than used elsewhere, say as scrap. Monopoly Theory of Profits: Another explanation of above-normal profits attributes them to the monopoly power enjoyed by firms. Firms with monopoly power restrict output and charge higher prices than under perfect competition. This causes above-normal profits to be earned by the monopolistic firms. Kalecki associated super-normal profits with monopoly power enjoyed by some firms. Because of strong barriers to the entry of new firms, monopoly firms can continue to earn economic profits even in the long run. Monopoly power may arise due to sole control over some essential raw material required for the production of a commodity, from economies of scale, from legal sanction or from ownership patents, from Government restrictions on the import of a commodity. Innovations Theory of Profits: This theory of profits explains that economic profits arise because of successful innovations introduced by the entrepreneurs. It has been held by Joseph Schumpeter that the main function of the entrepreneur is to introduce innovations in the economy and profits are reward for his performing this function. Now, what is innovation? Innovation, as used by Schumpeter, has a very wide connotation. Any new measure or policy adopted by an entrepreneur to reduce his cost of production or to increase the demand for his product is an innovation. Thus innovations can be divided into two categories. First types of innovations are those which reduce cost of production. In this first type of innovations are included the introduction of a new machinery, new and cheaper technique or process of production, exploitation of a new source of raw materials, a new and better method of orgainising the firm, etc. Second types of innovations are those which increase the demand for the product. In this category are included the introduction of a new product, a new variety or design of the product, a new and superior method of advertisement, discovery of new markets etc. If an innovation proves successful, that is, if it achieves its aim of either reducing the cost of production or increasing the demand for a product, it will give rise to profits. Profits emerge because due to successful innovations either cost falls below the prevailing price of the product or the entrepreneur is able to sell more and at a better price than before. It is here worth mentioning that profits caused by a particular innovation tend to be competed away as others imitate and also adopt it. An innovation ceases to be new or novel, when others also come to know of it and adopt it. When an entrepreneur introduces a new innovation, he is first in a monopoly position because the new innovation is confined to him only, He therefore makes large profits. When after some time others also adopt it in order to get a share, profits will disappear. If the law allows and the entrepreneur is able to get his new innovation e. For example, Xerox Corporation made large economic profits because it successfully developed and marketed a superior copying technology. Xerox continued to make large profits until other firms entered the field to compete away these super-normal profits earned by it. Likewise, Bill Gates introduced Windows operating system and MS-office types of computer software and has become billionaire by making huge profit on his innovations. Risk and Uncertainty Bearing Theory of Profit: This theory explains that profits are a necessary reward of the entrepreneur for bearing risk and uncertainty in a changing economy. So this is functional theory of profits. Profits arise as a result of uncertainty of future. Entrepreneurs have to undertake the work of production under conditions of uncertainty. In advance they have to make estimates of the future conditions regarding demand for the product and other factors which affect price and costs. In view of their estimates and anticipations, they make contract with the suppliers of factors of production in advance at fixed rates of remuneration. They realize the value of output produced by the hired factors after it has been produced and sold in the market. But a good deal of time is spent in the process of producing and selling the product. But between the times of contracts and sale of output many changes may take place which may upset anticipations for good or for worse and thereby give rise to profits, positive and negative. Now if the conditions prevailing at the time of the sale of output could be known or predicted when the entrepreneurs enter into contractual relationships with the factors of production about their rates of remuneration, there would have been no uncertainty and, therefore, no profits. Thus uncertainty, that is, ignorance about the future conditions of demand and supply, is the cause of profits. It should be noted that positive profits accrue to those entrepreneurs who make correct estimate of the future or whose anticipations prove to be correct. Those whose anticipations prove to be incorrect will have to suffer losses. Apart from the innovations which are introduced by the entrepreneurs themselves, changes which cause uncertainty are: All these changes cause uncertainty and bring profits, positive or negative, into existence. Knight who propounded the uncertainty theory of profits draws distinction between insurable and non-insurable risk. Risks of factory catching fire, occurrence of any theft or accident which may cause huge losses to the entrepreneur are the kinds of risk which can be ensured against on payment of an insurance premium which forms a part of the cost of production. But there are risks that cannot be insured. These non-insurable risks relate to the outcome of price-output decisions made by the entrepreneur. Due to uncertainty his decisions may prove to be right or wrong. What output he should produce, what price, higher or lower, he should fix for his output. In view of uncertainty about future conditions he cannot be sure whether, given his price and output decisions, he will make profits or losses. Similarly, he has to bear risk as a result of his decision regarding mode of advertisement and expenditure made on it, regarding variation in product design. For taking all these decisions he has to guess about demand and cost conditions and there is always a risk of incurring losses as a result of his business decisions. No insurance company can insure the entrepreneur against business losses which result from his particular price, output, product design, and advertisement expenditure which fall upon him due to adverse changes that may take place in the economy. Thus, it is non-insurable risks that involves uncertainty and gives rise to economic profits, positive or negative. Risk and uncertainty theory explains why super-normal profits that is economic profits are required by the firms who operate in such fields as petroleum exploration which involves relatively higher risks. Likewise, expected return on stocks has to be higher than the interest on bonds because of greater uncertainty and riskiness of investment in stocks of the companies. Managerial Efficiency Theory of Profits: Lastly, this theory recognizes that some firms are more efficient than others in terms of management of productive operations and successfully meeting the needs of consumers. Firms with average level of efficiency earns average rate of return. Firms with higher managerial skills and production efficiency are required to be compensated by above-normal profits i. Therefore, this theory is also called compensatory theory of profits. All the theories of profits explained above have some element of truth. No single theory can adequately explain the existence of profits in all cases. Thus, economic profits can arise as a result of disequilibrium caused by dynamic changes in the economy and frictions in the instantaneous adjustment to the new conditions. They can arise due to the existence of monopoly in the product and factor markets, due to the introduction of innovations by the entrepreneurs, due to higher risk and correctly estimating the uncertain future and due to higher managerial efficiency and skills.