

Economic Profit

Economic profit is the profit that remains when an adequate cost of capital is deducted from accounting profit. When most people calculate their profit from an investment the traditional way, they overlook the fact that the amount of money they invested has a cost. It could have been invested in something else and the return they gave up by not investing it in that “something else” is a cost.

Economic profit does not overlook this cost. Economic profit tries to factor this cost into the equation. Economic profit is revenue minus cost minus the cost of capital.

A firm that is earning a negative economic profit may not necessarily be losing money. It may be profitable (using an accounting profit definition), but it may not be earning its cost of capital. A firm in this situation can stay in business indefinitely; but it should not. And investors should not invest in firms that fit this description.