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An image of dollar bills and a text costs. In the subjects of economics, accounting, and business studies, the concept of cost is critical in understanding cost control, efficiency, profit calculation, breakeven analysis, optimisation, and many other topics. There are different types of costs, and in my student life, I remained confused about the true meaning and use of different types of costs in decision-making. In this article, I will explain the meaning of implicit and explicit costs and their use in decision-making. What is a Cost? Cost refers to the sacrifice of financial resources in order to get some benefit in the future. There are many types of costs, including fixed costs, variable costs, semi-variable costs, short-run costs, long-run costs, marginal costs, total costs, average costs, direct costs, indirect costs, and many more. In this article, we will focus on explaining the concept and use of implicit and explicit costs. Implicit costs are the actual expenses that are incurred when producing certain goods or services. Explicit costs are out-of-pocket expenses. Explicit costs are recorded in the books of accounts and are mentioned in financial records like the income statement and balance sheet. Explicit costs are also called accounting costs. Wages paid to employees, rent expenses, the cost of raw materials, advertising costs, building or land costs, formal salary (annual salary) which the corporate firm pays, depreciation of goods and other assets, cost of purchasing the tangible assets like furniture, utility costs (utility bills) and shipping costs are some examples of explicit costs. Economic Cost = Economic cost is the sum of explicit cost and implicit cost. In other words, it is the sum of accounting cost and opportunity cost. Economic cost is greater than accounting cost because of the addition of opportunity cost. The formula for calculating economic cost is given below: Economic Cost = Accounting Cost + Opportunity Cost. Economic Cost = Explicit Cost + Implicit Cost. An image of economic cost formula. Difference between Implicit Costs and Explicit Costs. The following table summarises the main points of difference between implicit cost and explicit cost. A table containing the main points of difference between implicit cost and explicit cost. Total Revenue/Total Revenue refers to the total amount of money earned by a business firm by selling goods and services in a given period of time. This is the income earned by selling a firm's product. Total revenue is equal to the price of the product times the quantity of output sold. The formula for calculating total revenue is given below: An image of total revenue formula. Profit. The difference between total revenue and total cost is called profit. The main objective of almost all the private sector businesses, regardless of their size or complexity, is to increase profit. The formula for calculating total profit is given below: Profit = Total Revenue - Total Cost. An image of profit formula. Accounting profit and economic profit are the two main types of profit. Accounting Profit. The difference between the total revenue and total explicit costs (accounting costs) of a business is called the accounting profit. Accounting profit is a profit that can be calculated by using explicit costs mentioned in the income statement. The implicit costs or opportunity costs are not included or considered in the accounting profit. Accounting profit is used to calculate the profitability of a business operating in a market. The formula for calculating accounting profit is given below: Accounting profit = Total Revenue - Accounting Cost. Accounting Profit = Total Revenue - Explicit Cost. An image of accounting profit formula. Economic Profit. Economic profit is the difference between total revenue and economic cost which is composed of both explicit and implicit costs. The formula for calculating economic profit is given below: Economic Profit = Total Revenue - Economic Cost. Economic Profit = Total Revenue - (Explicit Cost + Implicit Cost). An image of economic profit formula. There are three types of economic profit, which are given below. If economic profit is positive, it is called abnormal profit or supernormal profit. If economic profit is zero, it is called normal profit. If economic profit is negative, it is called subnormal profit or loss. Difference between Accounting Profit and Economic Profit. The following table summarises the main points of difference between accounting profit and economic profit. A table containing the main points of difference between accounting profit and economic profit. Understanding Accounting and Economic Profits with Calculation Examples. Let's understand the concepts of accounting profit and economic profit with the help of calculation examples. Suppose that a business has earned total revenue of \$40000 and its explicit cost is \$15000 for the same time period. Here, Total Revenue = \$40000. Explicit Cost = \$15000. We can easily calculate the accounting profit as follows: Accounting Profit = Total Revenue - Explicit Cost. Accounting Profit = \$40000 - \$15000 = \$25000. Now, suppose that the implicit cost (opportunity cost) is \$13000. The economic cost can be calculated as follows: Economic Cost = Explicit Cost + Implicit Cost. Economic Cost = \$15000 + \$13000 = \$28000. Now we can calculate economic profit as follows: Economic Profit = Total Revenue - Economic Cost. Economic Profit = \$40000 - \$28000 = \$12000. Since this economic profit is positive, it is called abnormal profit or supernormal profit. Importance of Implicit Costs. The importance of implicit costs is explained as follows: Opportunity Cost. Implicit cost is the opportunity cost of making a decision, and it is considered an expense in economics. Profit Calculation. By considering explicit costs along with implicit costs, a comprehensive calculation of economic profit is made. This helps in evaluating different options when making decisions about resource allocation. Decision-making. Implicit cost allows us to make informed decisions by identifying opportunity cost. Individuals and firms can make better decisions in which not only explicit costs are considered but also implicit costs are included for all the available options. This will improve the quality of decision making. Resource Allocation. Efficiency. Individuals and firms consider various options of resource allocation and evaluate them in a better way by considering implicit costs. This helps the business firms in improving efficiency in resource allocation. Importance of Explicit Costs. The importance of the explicit costs is explained as follows: Financial Accounting. Explicit costs are recorded in the books of accounts. This helps the business to keep the accurate record of all the expenses incurred and hence provide financial accountability. Profit Calculation. Profit calculations are critical for any business in assessing its financial performance. The explicit costs are used to calculate accounting profits which give a good indication of the financial performance of a business. Cost Control. By keeping the record of the explicit costs, businesses can control costs. This will improve business efficiency and profits. Pricing and Budgeting. Explicit costs help business firms in making pricing decisions for their products and budget for their operations. Setting the right price and making use of budgets is important for improving business performance. Compliance. Explicit costs provide compliance along with accounting standards and reporting information, which provide accurate information to stakeholders in their business. Importance of Accounting Profit. The importance of the accounting profit is explained as follows: Performance Evaluation. Accounting profit is used to evaluate the financial performance of a business for a specific period of time. This helps various stakeholders in making better financial decisions. Investor Confidence. Investors consider the values and trends in accounting profits in making investment decisions. A business showing an increasing trend of the accounting profit gives its investors the confidence for making investment decision in its favour. Taxation and Compliance. Accounting profit helps to calculate taxes and provide compliance with financial performance and regulations. Importance of Economic Profit. The importance of economic profit is explained as follows: True Measure of Performance. Economic profit goes beyond accounting profit by considering both explicit and implicit costs, providing a more accurate measure of a business's overall financial performance. Opportunity Cost. While calculating true economic profit, we use economic cost in which opportunity cost or implicit cost is also included. This helps the businesses in evaluating the true value of alternative uses of resources and hence, better decisions can be made. Long-Term Viability. Economic profit helps assess the long-term sustainability of a business by considering all costs, including foregone opportunities, and determining if the business is generating enough profit to cover all expenses. Resource Allocation. Efficiency. By considering economic profit, businesses can allocate resources more efficiently, focusing on activities that generate the highest returns after the consideration of all the costs. Conclusion. In conclusion, implicit cost is the opportunity cost of making a decision. This cost is not recorded in financial statements of a business, yet they are considered vital for making decisions. On the other hand, explicit costs are the actual expenses that are incurred in a business when producing goods or services. These are out-of-pocket costs. These costs are recorded in the books of accounts and are vital in cost control, financial efficiency, pricing, and profit calculations. These costs include costs of inputs used in production, office rental, cost of utilities, marketing expense and other monetary transactions. Both of the definitions of cost are important in understanding two different conceptions of profit, however, the consideration of implicit costs in decision making is a major advantage of economists over other writers. Private enterprise, the ownership of businesses by private individuals, is a hallmark of the U.S. economy. When people think of businesses, often giants like Wal-Mart, Microsoft, or General Motors come to mind. But firms come in all sizes, as shown in Table 2.1. The vast majority of American firms have fewer than 20 employees. As of 2010, the U.S. Census Bureau counted 5.7 million firms with employees in the U.S. economy. Slightly less than half of all the workers in private firms are at the 17,000 large firms, meaning they employ more than 500 workers. Another 35% of workers in the U.S. economy are at firms with fewer than 100 workers. These small-scale businesses include everything from dentists and lawyers to businesses that mow lawns or clean houses. Indeed, Table 2.1 does not include a separate category for the millions of small "non-employer" businesses where a single owner or a few partners are not officially paid wages or a salary, but simply receive whatever they can earn. Table 2.1 Range in Size of U.S. Firms (Source: U.S. Census, 2010 www.census.gov) Number of Employees ( % of total firms) Number of Paid Employees ( % of total employment) Total 5,734,538 12.0 million 0-9 543,315 (9.2%) 12.3 million (1.0%) 10-19 817,089 (14.3%) 18.6 million (1.6%) 20-99 475,125 (8.3%) 18.6 million (1.6%) 100-499 81,773 (1.4%) 15.9 million (14.2%) 500 or more 17,236 (0.30%) 50.9 million (49.2%) Each of these businesses, regardless of size or complexity, tries to earn a profit: Profit = Total Revenue - Total Cost. Total revenue is the income brought into the firm from selling its products. It is calculated by multiplying the quantity of product times the price of the product. Total Revenue = Price x Quantity. We will see in the following modules that revenue is a function of the demand for the firm's products. We can distinguish between two types of cost: explicit and implicit. Explicit costs are out-of-pocket costs, that is, payments that are actually made. Wages that a firm pays its employees or rent that a firm pays for its office are explicit costs. Implicit costs are more subtle, but just as important. They represent the opportunity cost of using resources already owned by the firm. Often for small businesses, they are resources contributed by the owners; for example, working in the business while not getting a formal salary, or using the ground floor of a home as a retail store. Implicit costs also allow for depreciation of goods, materials, and equipment that are necessary for a company to operate. These two definitions of cost are important for distinguishing between two conceptions of profit, accounting profit and economic profit. Accounting profit is a cash concept. It means total revenue minus explicit costs—the difference between dollars brought in and dollars paid out. Economic profit is total revenue minus total cost, including both explicit and implicit costs. The difference is important because even though a business pays income taxes based on its accounting profit, whether or not it is economically successful depends on its economic profit. Consider the following example. Fred currently works for a corporate law firm. He is considering opening his own legal practice, where he expects to earn \$200,000 per year once he gets established. To run his own firm, he would need an office and a law clerk. He has found the perfect office, which rents for \$50,000 per year. A law clerk could be hired for \$35,000 per year. If these figures are accurate, would Fred's legal practice be profitable? Step 1. First you have to calculate the costs. You can take what you know about explicit costs and total them: Office rental \$50,000 Law clerk's salary = \$35,000 Total explicit costs \$85,000 Step 2. Subtracting the explicit costs from the revenue gives you the accounting profit. Revenues: \$200,000 Explicit costs: -\$85,000 Accounting profit: \$115,000 But these calculations consider only the explicit costs. To open his own practice, Fred would have to quit his current job, where he is earning an annual salary of \$125,000. This would be an implicit cost of opening his own firm. Step 3. You need to subtract both the explicit and implicit costs to determine the true economic profit. Economic profit = total revenues - explicit costs - implicit costs = \$200,000 - \$85,000 - \$125,000 = -\$10,000 per year. Fred would be losing \$10,000 per year. That does not mean he would not want to open his own business, but it does mean he would be earning \$10,000 less than if he worked for the corporate firm. Implicit costs can include other things as well. Maybe Fred values his leisure time, and starting his own firm would require him to put in more hours than at the corporate firm. In this case, the lost leisure would also be an implicit cost that would subtract from economic profits. Now that we have an idea about the different types of costs, let's look at cost structures. A firm's cost structure in the long run may be different from that in the short run. We turn to that distinction in the next section. Self Check: Explicit and Implicit Costs Answer the question(s) below to see how well you understand the topics covered in the previous section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times. You'll have more success on the Self Check if you've completed the Reading in this section. Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section. Our accounting software starts at \$20/month, and our payroll software starts at \$17/month + \$4 per worker. All software products come with a free 30-day trial, then 50% off for 3 months. You can view our full pricing here. An implicit cost is a cost that involves no exchange of money and is not necessarily shown or reported as a separate expense. It represents an opportunity cost that arises when a company takes what you know about explicit costs and total them: Office rental \$50,000 Law clerk's salary = \$35,000 Total explicit costs \$85,000 Step 2. Subtracting the explicit costs from the revenue gives you the accounting profit. Revenues: \$200,000 Explicit costs: -\$85,000 Accounting profit: \$115,000 But these calculations consider only the explicit costs. To open his own practice, Fred would have to quit his current job, where he is earning an annual salary of \$125,000. This would be an implicit cost of opening his own firm. Step 3. You need to subtract both the explicit and implicit costs to determine the true economic profit. Economic profit = total revenues - explicit costs - implicit costs = \$200,000 - \$85,000 - \$125,000 = -\$10,000 per year. Fred would be losing \$10,000 per year. That does not mean he would not want to open his own business, but it does mean he would be earning \$10,000 less than if he worked for the corporate firm. Implicit costs can include other things as well. Maybe Fred values his leisure time, and starting his own firm would require him to put in more hours than at the corporate firm. In this case, the lost leisure would also be an implicit cost that would subtract from economic profits. Attributions "7.1 Building Producer Theory" in Principles of Microeconomics by Dr. Emma Hutchinson, University of Victoria is licensed under a Creative Commons Attribution 4.0 International License, except where otherwise noted. "7.1 Explicit and Implicit Costs, and Accounting and Economic Profits" in Principles of Economics 2e by OpenStax is licensed under Creative Commons Attribution 4.0 International License. "Chapter 6 Firms and their Production Decisions" in Intermediate Microeconomics by Patrick M. Emerson is licensed under a Creative Commons Attribution-NonCommercial-ShareAlike 4.0 International License, except where otherwise noted. When we hear the term "cost," most of us immediately think about the money that leaves our pockets. But in the world of economics, costs are much more nuanced than just monetary expenditure. Understanding economic costs is crucial for businesses, policymakers, and anyone interested in how resources are allocated. In this blog, we're going to dive deep into the realm of economic costs, exploring the concepts of explicit and implicit costs and their significance in determining economic profits. Table of Contents Economic costs are the total costs incurred by a firm in the production of goods and services. These costs encompass both explicit and implicit costs. While explicit costs are straightforward and straightforward to calculate, implicit costs require a deeper understanding of opportunity costs and resource allocation. Explicit costs: The visible expenditures Explicit costs, also known as accounting costs, are the direct, out-of-pocket payments made to suppliers of productive factors. These are the costs that show up on a company's financial statements and are easy to identify and measure. Examples of explicit costs include: Wages and salaries: Payments made to employees for their labor. Rent: Payments made for leasing office space, factories, or equipment. Raw materials: Costs incurred in purchasing inputs required for production. Utilities: Expenses for electricity, water, and other utilities used in the production process. Interest payments: Costs of borrowing money. Explicit costs are crucial for calculating a firm's accounting profit, which is simply total revenue minus explicit costs. However, accounting profit doesn't give the full picture of a firm's profitability, which is where implicit costs come into play. Implicit costs, also known as imputed or opportunity costs, represent the value of resources used in their next best alternative use. These costs are not directly paid out but are equally important in understanding the true cost of doing business. Implicit costs consider what the firm sacrifices by using its resources in the current manner instead of the next best alternative. Examples of implicit costs include: Foregone salary: If the owner of a business could earn a salary working elsewhere, this foregone salary is an implicit cost. Foregone rent: If a firm owns the building it operates in, the potential rental income it sacrifices by using the space itself is an implicit cost. Time and effort: The opportunity cost of the owner's time and effort that could be spent on other ventures. Implicit costs are often overlooked in traditional accounting but are crucial for calculating economic profit. Economic profit is the firm's total revenue minus both explicit and implicit costs, providing a more comprehensive measure of a firm's profitability and efficiency in resource allocation. Understanding opportunity cost Opportunity cost is the cornerstone of implicit costs. It is the value of the next best alternative that is forgone when a decision is made. For example, if a student decides to attend college, the opportunity cost is the income they could have earned if they had worked instead. Similarly, for businesses, the opportunity cost of using capital, labor, and other resources in a particular way includes the potential benefits these resources could have generated in their best alternative use. Opportunity costs are pervasive in everyday life and business decisions. They force us to recognize that every choice involves trade-offs, and understanding these trade-offs is essential for making informed decisions. By incorporating opportunity costs into their calculations, businesses can better assess the true economic impact of their decisions and optimize resource allocation. Economic costs and economic profit To truly understand a firm's profitability, it's essential to consider both explicit and implicit costs. While accounting profit is calculated by subtracting explicit costs from total revenue, economic profit takes it a step further by also subtracting implicit costs. This distinction is vital for several reasons: Comprehensive insight: Economic profit provides a more comprehensive understanding of a firm's profitability by accounting for all costs, including opportunity costs. Resource allocation: By considering implicit costs, firms can better evaluate the efficiency of resource allocation and make informed decisions to maximize profits. Long-term sustainability: Understanding economic profit helps firms gauge their long-term sustainability and competitiveness in the market. For example, a business may show a positive accounting profit but a negative economic profit. This indicates that the resources used in the business could generate higher returns if employed elsewhere. In such cases, the firm may need to reconsider its strategy and allocation of resources to enhance profitability. Real-world examples of economic costs Let's look at some real-world examples to better understand the concepts of explicit and implicit costs. Example 1: The tech startup Imagine a tech startup founded by an entrepreneur who previously worked as a software engineer earning \$1,000,000 per year. The entrepreneur invests \$500,000 of their savings into the startup, which could have earned 5% interest annually if invested elsewhere. In the first year, the startup incurs the following explicit costs: Wages for employees: \$600,000 Rent for office space: \$200,000 Raw materials and utilities: \$100,000 Total explicit costs = \$600,000 + \$200,000 + \$100,000 = \$900,000 To calculate the implicit costs: Foregone salary: \$1,000,000 Foregone interest: \$500,000 \* 5% = \$25,000 Total implicit costs = \$1,000,000 + \$25,000 = \$1,025,000 If the startup generates total revenue of \$2,000,000 in the first year: Accounting Profit = Total Revenue - Explicit costs = \$2,000,000 - \$900,000 = \$1,100,000 Economic Profit = Total Revenue - (Explicit costs + Implicit costs) = \$2,000,000 - (\$900,000 + \$1,025,000) = \$75,000 In this case, while the startup shows a healthy accounting profit, the economic profit is relatively small, indicating that the entrepreneur's resources could potentially generate higher returns elsewhere. Example 2: The family-owned restaurant Consider a family-owned restaurant where the owner manages the operations and doesn't take a salary. The restaurant operates in a building owned by the family, which could be rented out for \$300,000 per year. The explicit costs for the restaurant include: Wages for staff: \$500,000 Cost of ingredients: \$300,000 Utilities and maintenance: \$100,000 Total explicit costs = \$500,000 + \$300,000 + \$100,000 = \$900,000 To calculate the implicit costs: Foregone rent: \$300,000 Foregone salary for the owner: \$400,000 (potential salary if the owner worked elsewhere) Total implicit costs = \$300,000 + \$400,000 = \$700,000 If the restaurant generates total revenue of \$1,800,000 in a year: Accounting Profit = Total Revenue - Explicit costs = \$1,800,000 - \$900,000 = \$900,000 Economic Profit = Total Revenue - (Explicit costs + Implicit costs) = \$1,800,000 - (\$900,000 + \$700,000) = \$200,000 In this scenario, the restaurant has a positive economic profit, indicating that the family's resources are being efficiently utilized in the current business. Conclusion Understanding economic costs is essential for anyone involved in business, economics, or resource management. By considering both explicit and implicit costs, we gain a more comprehensive view of profitability and resource allocation. Economic profit, which accounts for opportunity costs, provides valuable insights into the true efficiency and sustainability of a business. What do you think? Have you ever considered the implicit costs in your personal or business decisions? How might this understanding influence your future choices? By the end of this section, you will be able to: Describe the difference between explicit costs and implicit costs Explain the relationship between cost and revenue Each business, regardless of size or complexity, tries to earn a profit: Profit = Total Revenue - Total Cost. Total revenue is the income the firm generates from selling its products. We calculate it by multiplying the price of the product times the quantity of output sold: Total Revenue = Price x Quantity. We will see in the following chapters that revenue is a function of the demand for the firm's products. Total cost is what the firm pays for producing and selling its products. Recall that production involves the firm converting inputs to outputs. Each of those inputs has a cost to the firm. The sum of all those costs is total cost. We will learn in this chapter that short-run costs are different from long-run costs. We can distinguish between two types of cost: explicit and implicit. Explicit costs are out-of-pocket costs, that is, actual payments. Wages that a firm pays its employees or rent that a firm pays for its office are explicit costs. Implicit costs are more subtle, but just as important. They represent the opportunity cost of using resources that the firm already owns. Often for small businesses, they are resources that the owners contribute. For example, working in the business while not earning a formal salary, or using the ground floor of a home as a retail store are both implicit costs. Implicit costs also include the depreciation of goods, materials, and equipment that are necessary for a company to operate. (See the Work It Out feature for an extended example.) These two definitions of cost are important for distinguishing between two conceptions of profit, accounting profit, and economic profit. Accounting profit is a cash concept. It means total revenue minus explicit costs—the difference between dollars brought in and dollars paid out. Economic profit is total revenue minus total cost, including both explicit and implicit costs. The difference is important because even though a business pays income taxes based on its accounting profit, whether or not it is economically successful depends on its economic profit. WORK IT OUT Calculating Implicit Costs Consider the following example. Fred currently works for a corporate law firm. He is considering opening his own legal practice, where he expects to earn \$200,000 per year once he establishes himself. To run his own firm, he would need an office and a law clerk. He has found the perfect office, which rents for \$50,000 per year. He could hire a law clerk for \$35,000 per year. If these figures are accurate, would Fred's legal practice be profitable? Step 1. First you have to calculate the costs. You can take what you know about explicit costs and total them: Office rental: \$50,000 Law clerk's salary: +\$35,000 Total explicit costs: \$85,000 Step 2. Subtracting the explicit costs from the revenue gives you the accounting profit. Revenues: \$200,000 Explicit costs: -\$85,000 Accounting profit: \$115,000 However, these calculations consider only the explicit costs. To open his own practice, Fred would have to quit his current job, where he is earning an annual salary of \$125,000. 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A firm had sales revenue of \$1 million last year. It spent \$600,000 on labor, \$150,000 on capital, and \$200,000 on materials. What was the firm's accounting profit? Continuing from Exercise 6.1, the firm's factory sits on land owned by the firm that it could rent for \$30,000 per year. What was the firm's economic profit last year? Share — copy and redistribute the material in any medium or format for any purpose, even commercially. Adapt — remix, transform, and build upon the material for any purpose, even commercially. The licensor cannot revoke these freedoms as long as you follow the license terms. Attribution — You must give appropriate credit, provide a link to the license, and indicate if changes were made. You may do so in any reasonable manner, but not in any way that suggests the licensor endorses you or your use. ShareAlike — If you remix, transform, or build upon the material, you must distribute your contributions under the same license as the original. 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