

Lesson 13: Profit and Loss Accounting

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Table of Contents

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1. Lesson 13: Profit and Loss Accounting

4. Chapter: Lesson 13: Profit and Loss Accounting

1. Lesson 13: Profit and Loss Accounting Questions

4.1.1. Explain: "Entrepreneurs do not respond to particular prices but rat..."

Author: Robert Murphy

Explain: "Entrepreneurs do not respond to particular prices but rather to the difference between certain prices."

- Most entrepreneurs are not out to maximize revenues, but rather to earn profits. Monetary profit is the difference between the revenues from customers and the expenditures on inputs. Just because a particular price is very high doesn't automatically mean that entrepreneurs rush to produce the item in question; the expenses involved in producing the item might be really high too.

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4.1.2. Explain: "In a market economy with open competition, there is a ten..."

Author: Robert Murphy

Explain: "In a market economy with open competition, there is a tendency for monetary profits and losses to be whittled away over time, as entrepreneurs adjust to the situation."

- If the prices in a certain industry allow the firms to reap large monetary profits, this will tend to attract competitors. By producing more of the finished good (or service), they push down its price, and by buying more of the inputs needed to produce it, they push up the costs of production. Thus the overall profit margin shrinks. The reverse happens in an industry suffering from monetary losses.

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4.1.3. *How does interest relate to profit, specifically the difference be...

Author: Robert Murphy

*How does interest relate to profit, specifically the difference between accounting and economic profit?

- In everyday language, and even in terms of standard accounting, "profit" refers to the excess of money receipts over money expenditures. But this figure includes the interest payment on the invested capital in the business. In other words, out of the gross or accounting profit we need to subtract the interest payment reflecting the fact that the investors' capital was tied up for a certain period when it could have been "at work" in another project.

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4.1.4. In what sense do consumers—rather than the "captains of industry"—g...

Author: Robert Murphy

In what sense do consumers—rather than the "captains of industry"—guide the production decisions in a market economy?

- With their spending decisions, consumers provide guidance to entrepreneurs, to the extent that they allow themselves to be steered by considerations of (monetary) profit.
It is the spending of smokers that leads farmers to plant tobacco.

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4.1.5. Does a market economy force entrepreneurs to do whatever makes the ...

Author: Robert Murphy

Does a market economy force entrepreneurs to do whatever makes the most profit?

- No, in a market economy the owner determines the fate of a particular unit of resources (including labor services). No matter how high the price of cigarettes, a farmer doesn't have to plant tobacco if he doesn't want to. But market prices do allow resource owners to make informed decisions. They get a sense of how much other people want to encourage them to use their resources in a particular way.

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4.1.6. Explain why, generally speaking, activities that generate high (mon...

Author: Robert Murphy

Explain why, generally speaking, activities that generate high (monetary) profits will attract more entrepreneurs, while those that cause losses will repel entrepreneurs.

- Although there are other motivations, generally speaking people go into business to earn monetary profits. In general, entrepreneurs will mimic those activities that are generating monetary profits for other people, and they will stop doing those activities that are causing losses. By acting in this fashion, entrepreneurs try to earn as much monetary profit as they can, other things equal.

Sample Partial Credit Answer

If a business keeps losing money, eventually it will go bankrupt.

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4.1.7. Explain the distinction economists often make between interest and ...

Author: Robert Murphy

Explain the distinction economists often make between interest and profit.

- Gross or accounting profit is total revenue minus out-of-pocket expenditures. However, this calculation ignores the interest on the invested capital. Even if a business venture "makes money," if the investor could have ended up with even more money through a different (and equally safe) investment, then in a sense the investor actually suffered a loss.

Sample Partial Credit Answer

Profit can mislead if it doesn't include interest.

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4.1.8. Does the profit and loss system force movie theaters to stay open o...

Author: Robert Murphy

Does the profit and loss system force movie theaters to stay open on Christmas? Explain.

- No, the owners of theaters always have the ability to keep them closed on holidays. Yet very few owners exercise this right, because it is so profitable to have movies open on holidays. The profit and loss system communicates to the owners how much people want to watch movies on their holiday breaks.
Sample Partial Credit Answer
No, they can close down if they want to.

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Question: [Does the profit and loss system force movie by Dr. Robert Murphy](#)

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4.1.9. Explain how the profit and loss system communicates the desires of ...

Author: Robert Murphy

Explain how the profit and loss system communicates the desires of consumers to resource owners and entrepreneurs.

- Through their spending decisions, consumers give entrepreneurs the money with which they bid on worker hours, oil, land, equipment, and other inputs. The prices of the inputs reflect how urgently those resources are needed in certain lines, to produce particular goods and services that some consumers desire. Loosely speaking, a profitable business is taking undervalued resources and transforming them into outputs that have a higher value, while an unprofitable business is wasting resources on projects that are not as valuable as alternatives.
Sample Partial Credit Answer
If consumers want something they will pay a lot for it.

Check the answer of this question online at QuizOver.com:

Question: [Explain how the profit and loss system communicates by Dr. Robert](#)

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4.1.10. If smoking is bad for you, then why do farmers grow tobacco?

Author: Robert Murphy

If smoking is bad for you, then why do farmers grow tobacco?

- Some consumers are smokers and are willing to pay a lot of money for cigarettes. Companies then find it worthwhile to spend a lot on tobacco in order to produce cigarettes. The high price of tobacco makes it attractive for some farmers to plant it, rather than other crops.

Sample Partial Credit Answer

To make money.

Check the answer of this question online at QuizOver.com:

Question: [If smoking is bad for you then why do farmers by Dr. Robert Murphy](#)

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