If it is important to you, you will find a way
If not, you will find an excuse.
Frank Banks

Test Yourself: The Business Firm

What is a business firm?

A business firm is an institution that hires and organizes resources to produce and sell goods and services.

The objective of a firm is to maximize economic profit.

What is a proprietorship?

A proprietorship is a business owned by one individual who makes the business decisions, receives all of the profits and is legally responsible for all of the debts of the firm.

What is a partnership?

A partnership is a business owned by two or more co-owners, partners, who share the responsibilities and the profits of the firm and are individually liable for all of the debts of the partnership.

What is a corporation?

A corporation is a legal entity that may conduct business in its own name just as an individual does. The owners of a corporation, called shareholders, own shares of the firm’s profits and have limited liability.

What are the three methods of corporate financing?

The three corporate financing methods are:

share of stock

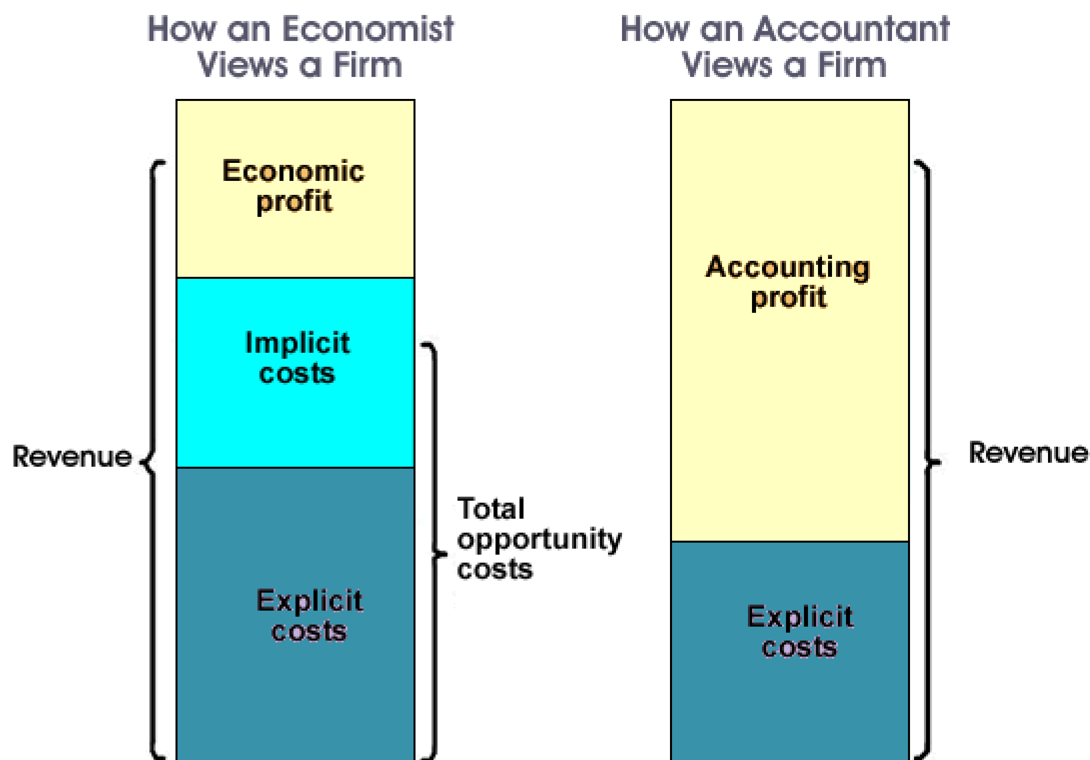
bond

reinvestment

On what do a firm's production decisions depend?

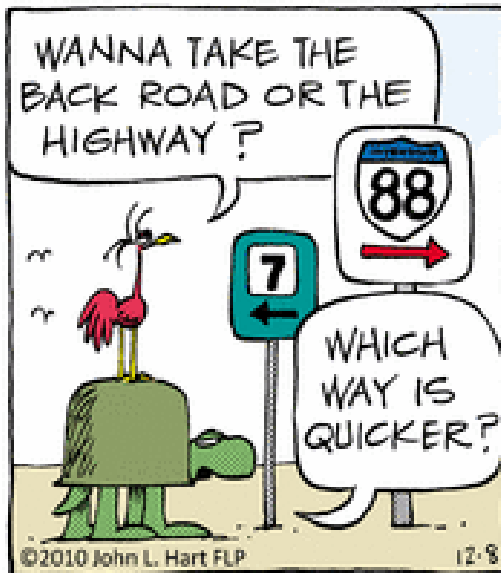
A firm’s production decisions depend on how those decisions affect **economic profit**.

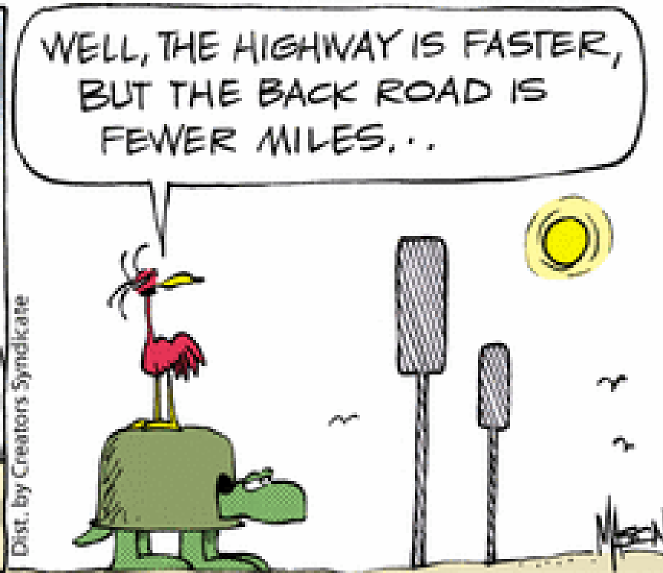
What is economic profit?

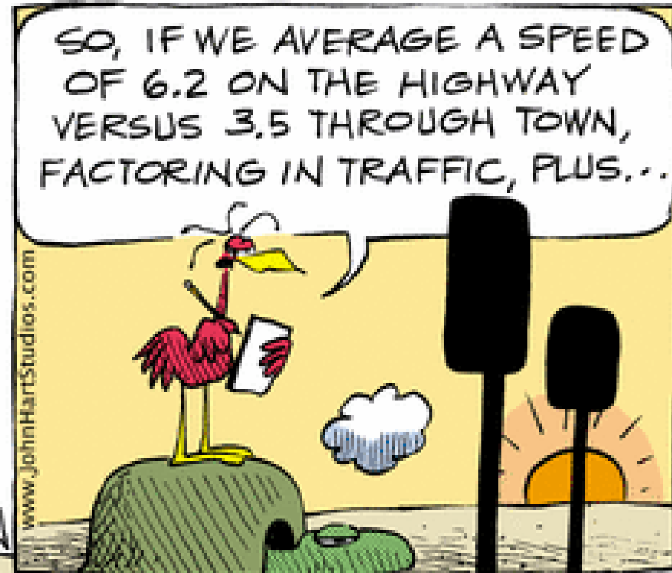


Economic profit equals revenue minus opportunity costs.

What kinds of costs comprise a firm's opportunity costs?







A firm's **opportunity costs** are divided into:

explicit costs

and

implicit costs.

What is explicit cost?

Explicit cost (money costs) is the amount a firm pays for its needed factors of production (land, labor, capital, entrepreneurship).

What is implicit cost?

Implicit cost is the value of foregone opportunities.

Implicit costs are non-money costs.

A firm incurs implicit cost when it
uses its own capital and
uses its owner’s time or financial resources.

What is a firm's implicit rental rate?

Implicit rental rate is the forgone income from using your assets, rather than renting them to other firms.

The implicit rental rate of capital is made up of **economic depreciation** and **implicit interest**.

What is economic depreciation?

Economic depreciation is the change in the market price of a piece of capital over a given time period … what you lose by not doing *something else* with that piece of capital.

This is an opportunity cost.

It is not the same as *accounting* depreciation, which involves using a number of conventional rules to determine the loss of value in a piece of capital over time.

What is implicit interest?

The funds tied up in capital goods could have been invested in other things that yield a return (e.g. interest income).

This is implicit interest, an opportunity cost.

What is the cost of the owner's resources?

The cost of the owner's resources is the income that the owner could have earned in the best alternative job.

What is normal profit?

Normal profit is the expected return for supplying entrepreneurial ability.

What is a firm's objective?

A firm's objective is to maximize economic profit.

What limits a firm's profit?

A firm's profit is limited by:

- **market structure**
- the **technological constraints of production**. (*Technological* doesn't necessarily mean technology.)

Why is economic profit not the same as accounting profit?

Economic profit is not the same as accounting profit because opportunity cost is not identical to accounting cost.

What do we mean by technology constraints?

Opportunity

Constraint

The quantity of output is limited by the *productivity* of inputs.

These technology constraints are different depending on the time frame.

What is “the long run“?

The **long run** is a period of time in which the quantities of all inputs can be varied.

What is “the short run“?

The **short run** is a period of time in which the quantity of at least one input is fixed.

Table: Long Run vs. Short Run

Term	Definition
Short run period	• the time frame in which at least one of the inputs (factors of production) is fixed but the other inputs are varied. The example of short-run is building, equipment, tools, and others.
Long-run period	• the time frame in which all inputs are variable.
Fixed input	• an input in which the quantity does not change according to output. For example, machinery, land, building, tools, equipment, etc.
Variable input	• an input in which the quantity changes according to output. For example, raw materials, transportation, communication, etc.

What are some short run constraints?

Short run constraints include:

An increase in output in the short run: The firm must increase the use of labor.

Total product is the total output produced.

Marginal product is the increase in total product from a one-unit increase in an input.

Average product of an input is the total product divided by the quantity of an input.

…*ceteris paribus*

How do we measure marginal product?

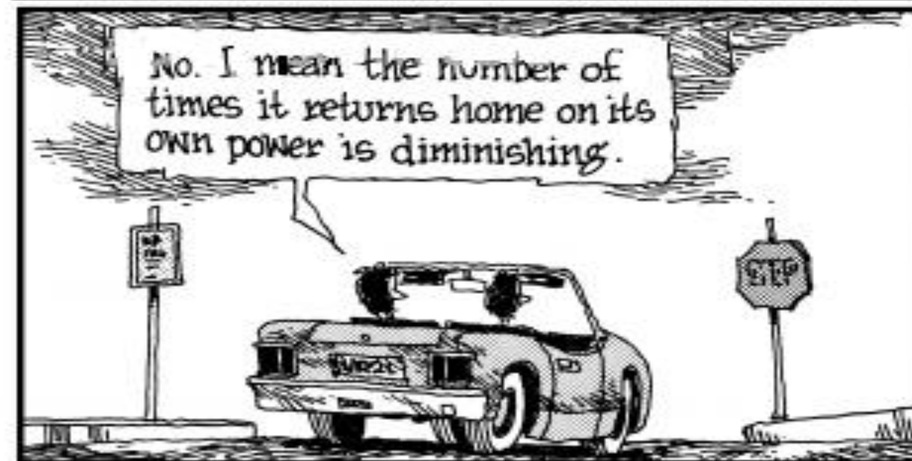
Marginal product is measured by the slope of the total product curve.

Increasing marginal returns occur when the marginal product of an additional worker exceeds that of the previous worker.

Decreasing marginal returns occur when the marginal product of an additional worker is less than that of the previous worker.

What is the law of diminishing returns?

The 5th Wave By Rich Tennant



The law of diminishing returns says that as a firm uses more of a variable input, with a given quantity of fixed inputs, the marginal product of the variable input eventually diminishes.

What is the average product of an input?

The average product of an input is the total product divided by the quantity of an input.

In a two input model:

Capital is fixed in the short run (a *fixed* input).

Labor – The amount can be varied (a *variable* input).

Give some examples of how marginal product and average product curves interact.

The MP curve is above the AP curve.
AP is rising: With 1 worker per day, MP exceeds AP, so AP rises.

The MP curve intersects the AP curve at its maximum point.
MP equals AP: With 2 workers per day, MP equals AP, so AP is at its maximum.

The MP curve is below the AP curve.
AP is falling: With more than 2 workers per day, MP is less than AP, so AP falls.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.

" Our first mistake was hiring an honest accounting firm. "

THE END