



TEST YOURSELF: PROFIT MAXIMIZATION

There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits.

Milton Friedman



What is the motivation for business decisions?



The motivation for business decisions is
profit maximization.



What is profit maximization?





Profit maximization is the short run or long run process by which a firm determines the price and output level that returns the greatest profit.



What is
economic profit?



To understand profit, we need to distinguish between the way economists measure costs and the way accountants measure costs.

Economic profit equals total revenue minus explicit costs and implicit costs, or total revenue minus total opportunity costs.



What are total opportunity costs?

Stu's Views

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**total opportunity costs =
explicit costs + implicit costs**

explicit cost – payments to nonowners of a firm for their resources

implicit cost – the opportunity costs of using resources owned by the firm. For example, when you invest your nest egg in your own business, you give up earning interest on that money.



What is normal profit?



Normal profit is the minimum profit necessary to keep a firm in operation. A firm that earns normal profits earns total revenue equal to its total opportunity cost.



How is accounting profit defined?



Accounting profit is total revenue minus total explicit costs.

Since business decision making is based on economic profit, rather than accounting profit, the word *profit* in this course always means economic profit.



What is a fixed input?



A **fixed input** is any resource for which the quantity cannot change during the period of time under consideration.



What is a
variable input?



A **variable input** is any resource for which the quantity can change during the period of time under consideration.



What is the short run?





The **short run** is a period of time so short that there is at least one fixed input.



What is the long run?



The **long run** is a period of time long enough that all inputs are variable.

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.



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