Chapter 53: Business objectives 2016-Nov-2

- *Control of the decision-making process*: Who is in control?
  - *Owners* of *shareholders*
    - the owner who runs the business will make the decisions about the business
    - small businesses (e.g., small local corner shop)
    - not the case as business gets bigger!
  - *Directors* and *managers*
    - shareholders (in a public limited company) *elect* directors
    - directors *appoint* managers for running the business
    - $\Rightarrow$ divorce between *ownership and control*
    - owners can *influence* decision making by sacking directors at the Annual General Meeting (AGM)
    - shareholders can sell their shares (share prices will drop) to make a company more *vulnerable* to a takeover bid
  - *Workers*
    - *trade unions* can put pressure on company
    - cannot *run the company*
    - but they can influence *wages*, *health and safety issues at work*, *relocation decisions*, ...
  - *State*
    - controls and regulates the *underlying framework* (e.g., legislation on taxation, envornment issues, consumer protection, health and safety at work, employment practices, solvency, ...)
  - *Consumer*
    - *Consumers' Association* or *trade organisations* can put pressure on companies (*weak influence*!)
    - Consumers' spending decision and preferences will affect decisions of companies
    - Companies will therefore try to *manipulate* consumer preferences
  - *Pressure groups*
    - try to influence others to advance a particular cause or viewpoint (e.g., Friends of the Earth, Oxfam, ...)
    - pressure groups have the power to change company policies
- *Short-run* profit maximisation
  - In *neo-classical economic theory*:

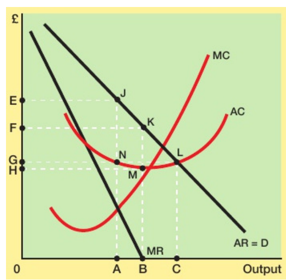
    * (Reminder: consumers attempt to *maximise their utility*)
    * interest of owners and shareholders are the most important $\Rightarrow$ goal of firms is to *profit maximise*
    * firms maximise *short-run profits* by equating $MC = MR$ to decide level of production
    * prices are
      · *stable* in markets with heavy branding (e.g., soap industry)
      · *unstable* in markets with homogeneous goods (e.g., commodities)

- *Long-run* profit maximisation
  - *Neo-Keynesian theory*
    * firms maximise their *long-run* profit rather than their short-run profit
    * this is based on the belief that firms use *cost plus pricing* techniques: price of a product is obtained by calculating the *average total cost of operating at full capacity* and adding a *profit mark-up*
    * the price set (and the profit aimed) is based on *long-run* costs of the firm
  - Reminder: Rapid price changes are happening in the *neo-classical* framework when firms adjust prices and output in response to market conditions
  - According to *neo-Keynesians* rapid price changes damage a firm's position in the market
  - Prices will be kept stable, and output will adjust
  - Firm may produce in *short run* even if it fails to cover its variable cost: if it thinks that in the *long run* it may make a profit
  - Firm may cease production in *short run* even if can cover its variable costs: if it thinks that price cutting in the short run would lead to a permanent effect on prices and profit in the long run

- Divorce of ownership from control
  - *small and medium firms*: owners are likely to work in the business
  - *large firms*: owners appoint directors and managers to run the business
    * large firms are often *listed companies* that are traded on *stock markets*
    * owners (shareholders) want to maximise the *returns on their investment* (short run profit maximisation)

    - directors and managers
        - maximise their own rewards (e.g., pay, bonuses, company cars, private medical care, power, ...)
        - they have to make enough profit to satisfy shareholders and markets (*profit satisficing*)

- Revenue maximisation
  - *Theory of revenue maximisation*: uses the concept of divorce of ownership from control
  - Assumption: Objective of managers is to maximise total revenues fro the firm, subject to a profit satisficing constraint
  - Total revenue will be maximised when *marginal revenue is zero*



  - Assume the firm is a *monopolist* and that the minimum level of profit which will satisfy shareholders is the level of *normal profit*
    - downward sloping MR curve
    - OB is the *revenue maximising* output level [OA would be the *profit maximising* output level ($MC = MR$)]
    - OF is the *revenue maximising* price level [this is lower than OE which is the *profit maximising* price level]
    - FKMH is the *revenue maximising* abnormal profit [this is smaller than the *profit maximising* abnormal profit given by EJNG]

- Sales maximisation
  - *Theory of firms' sales maximisation*
    - firms maximise their sales volumes
    - Assume that firm is a *monopoly* or an *oligopoly* which can make *abnormal profits* both in short and long runs
    - Sales are maximised when $AC = AR$ (or $TC = TR$)
    - Output level: OC
    - Price level: OG
    - Firm makes no *abnormal profits*

Table 1	
	Level of output (assuming the firm profit satisfices where it just makes normal profit) occurs when:
Profit maximiser	MC = MR
Revenue maximiser	MR = 0
Sales maximiser	AC = AR or TC = TR

- Review questions (pick the right answer and explain in detail!):
  - A firm engaged in *satisficing* behaviour is most likely to:
    - ☐ maximise profits
    - ☐ maximise revenue
    - ☐ maximise sales
    - ☐ minimise costs
    - ☐ produce at an output different to that of a profit maximising firm
  - The management at a famous football club aim to promote the firm's success in matches as their primary objective. The firm's shareholders indicate at a meeting that they will accept low dividends on their shares on the condition that the club invests in new players. This indicates that the
    - ☐ management is aiming for short-term gains in share prices
    - ☐ management is profit satisficing
    - ☐ management is profit maximising in the short run
    - ☐ firm cannot make supernormal profits in the long run
    - ☐ average variable cost of players is equal to the marginal revenue gained from their employment
  - A firm producing car tyres sells the largest amount possible consistent with earning normal profits. The short run objective of the firm is most likely to be
    - ☐ revenue maximisation
    - ☐ profit satisficing
    - ☐ sales maximisation
    - ☐ predatory pricing
    - ☐ maximisation of shareholder dividends
  - At the end of a day's trading a flower seller cuts the prices of all the stock that has reached its 'sell by' date. This pricing strategy is most likely to be
    - ☐ fixed cost pricing
    - ☐ limit pricing
    - ☐ revenue maximisation pricing

- ☐ predatory pricing
- ☐ productive efficiency pricing.

– Game theory can be used to illustrate which of the following examples of competitive behaviour?

- ☐ Price leadership in perfect competition
- ☐ Revenue maximisation in monopolistic competition
- ☐ Limit pricing in monopolistic competition
- ☐ Tacit collusion in oligopoly
- ☐ Price discrimination by a monopolist.