Chapter 8 Lecture - Firms, the Stock Market, and Corporate Governance

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The Firm and Its Economic Problem

A **firm** is an institution that hires factors of production and organizes them to produce and sell goods and services.

The Firm's Goal

- A firm's goal is to maximize profit.
- If the firm fails to maximize its profit, the firm is either eliminated or taken over by another firm that seeks to maximize profit.

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The Firm and Its Economic Problem

Accounting Profit

- Accountants measure a firm's profit to ensure that the firm pays the correct amount of tax and to show it investors how their funds are being used.
- Profit equals total revenue minus total cost.
- Accountants use Internal Revenue Service rules based on standards established by the Financial Accounting Standards Board to calculate a firm's depreciation cost.

Economic Accounting

- Economists measure a firm's profit to enable them to predict the firm's decisions, and the goal of these decisions is to maximize economic profit.
- **Economic profit** is equal to total revenue minus total cost, with total cost measured as the opportunity cost of production.

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The Firm and Its Economic Problem

A Firm's Opportunity Cost of Production

- A firm's opportunity cost of production is the value of the best alternative use of the resources that a firm uses in production.
- A firm's opportunity cost of production is the sum of the cost of using resources

Resources Supplied by the Firm's Owner

- The owner might supply both entrepreneurship and labor.
- The return to entrepreneurship is profit.
- The profit that an entrepreneur can expect to receive *on average* is called **normal profit**.
  - Normal profit is the cost of entrepreneurship and is an opportunity cost of production.
  - *In addition* to supplying entrepreneurship, the owner might supply labor but not take a wage.
  - The opportunity cost of the owner's labor is the wage income forgone by not taking the best alternative job.

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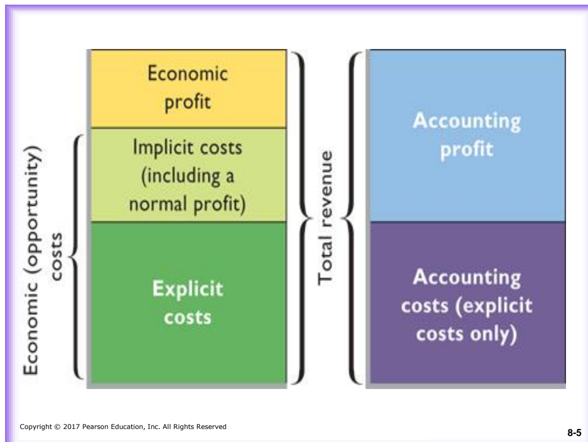

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The Firm and Its Economic Problem

The Firm's Decisions

To maximize profit, a firm must make five basic decisions:

1. What to produce and in what quantities
2. How to produce
3. How to organize and compensate its managers and workers
4. How to market and price its products
5. What to produce itself and what to buy from other firms

The Firm's Constraints

The firm's profit is limited by three features of the environment:

- Technology constraints
- Information constraints
- Market constraints

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Types of Firms

We can categorize the major types of firms in the United States.

Firms are legally categorized in the U.S. as one of the following:

Sole Proprietorships: Firms owned by a single individual and not organized as a corporation.

Partnerships: Firms owned jointly by two or more persons and not organized as a corporation.

Corporations: A legal form of business that provides owners with protection from losing more than their investment should the business fail.

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Who Is Liable? Limited and Unlimited Liability

In sole proprietorships and partnerships, no legal distinction is made between the *assets* of the firm and the assets of its owner(s).

Asset: Anything of value owned by a person or a firm.

This is not the case for corporations. The owners of corporations have **limited liability**, a legal provision shielding owners of the corporation from losing more than they have invested in the firm.

Limited liability makes raising funds easier for a firm; it also makes investing in firms easier for individuals.

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Table 8.1 Differences among Business Organizations

	Sole Proprietorship	Partnership	Corporation
Advantages	• Control by owner	• Ability to share work	• Limited personal liability
	• No layers of management	• Ability to share risks	• Greater ability to raise funds
Disadvantages	• Unlimited personal liability	• Unlimited personal liability	• Costly to organize
	• Limited ability to raise funds	• Limited ability to raise funds	• Possible double taxation of income

There is not a unique *best* business structure.

Corporations benefit from limited liability but are expensive to organize.

Also, their profits may be taxed twice: once as corporate profits, and again when the profits are disbursed to investors.

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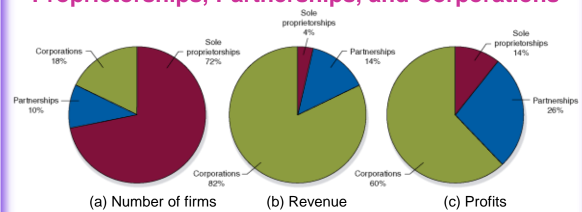
Figure 8.1 Business Organizations: Sole Proprietorships, Partnerships, and Corporations



(a) Number of firms (b) Revenue (c) Profits

Nearly ¾ of firms are sole proprietorships, and just one in six is a corporation.

But since larger firms tend to be corporations, most economic activity takes place through them.

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The Structure of Corporations and the Principal-Agent Problem

Corporate governance is the way in which a corporation is structured and the effect that structure has on the corporation's behavior.

While the board of directors and top management are, in theory, representing the interests of the firm owners, they may sometimes pursue their own agendas.

- *Example: Managers may procure for themselves a very high salary, or perks such as corporate private jets.*

The conflict between the interests of shareholders and the interests of top management is a *principal-agent problem.*

Principal-agent problem: A problem caused by an agent pursuing his own interests rather than the interests of the principal who hired him.

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Can the Principal-Agent Problem Be Resolved?

The principal-agent problem derives from economic incentives being improperly aligned.

A remedy for the problem must be based on aligning the interests.

- This is why many top managers are paid a large part of the salary in *stock* or *stock options*: their salary becomes tied to the performance of the firm.
- However since the CEO owns only a fraction of the firm, incentives can never be 100 percent aligned.

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How Firms Raise Funds

We explain how firms raise the funds they need to operate and expand.

Small business owners have three principal methods of raising funds:

Retained earnings

- Profits reinvested in the firm, instead of paid to firm owners.

Recruit additional owners

- Such an arrangement would increase the firm's *financial capital*.

Borrow

- From financial institutions, or from friends or family.

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Raising Funds as Your Firm Grows: Indirect Finance

As firms get larger, the need to obtain *external funds* tends to grow.

- The economy's *financial system* facilitates the transfer of funds from savers to borrowers.

Firms can borrow money from banks. As such, the banks are acting as *financial intermediaries*, permitting *indirect finance* of the firm by their savers.

Indirect finance: A flow of funds from savers to borrowers through financial intermediaries such as banks. Intermediaries raise funds from savers to lend to firms (and other borrowers).

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Raising Funds as Your Firm Grows: Direct Finance

Alternatively, firms can appeal directly to potential investors for funds.

- This is **direct finance**: the flow of funds from savers to firms through financial markets, such as the New York Stock Exchange.

Direct finance generally takes the form of one of two *financial securities*:

- **Bonds**: A financial security that represents a promise to repay a fixed amount of funds.
- **Stocks**: A financial security that represents partial ownership of a firm.

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Stock and Bond Markets Provide Capital—and Information

After firms sell their stocks and/or bonds, these financial securities can be traded in *stock and bond markets.*

The existence of these resale markets is beneficial for society, since without them, individuals could not invest in firms without tying up their money for a long time.

- The price at which a stock trades indicates the degree of confidence in the firm's ability to make future profits, since these profits are what is used to generate a return for investors.
- The price at which a bond trades is determined by its coupon payment, relative to other coupon payments available. But it also reflects the confidence of investors in the firm's ability to make those payments.

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