

Chapter 12 Objectives of business

Answers to Knowledge checks

- 12.1** If a firm were to operate at a level of output where marginal cost exceeded marginal revenue, it would be making a loss on the marginal unit produced, so it would increase profits if it were to reduce its output.
- 12.2** The conflict is likely to arise when the owners and managers have different motivations, and where the managers (the agents) are not fully accountable to the owners (the principals).
- 12.3** Sales volume maximisation is about the volume of sales, whereas sales revenue maximisation is concerned with the value of sales. The two may differ if the firm has to reduce its price in order to increase its sales.
- 12.4** Yes, this would be seen as organic growth, which is where a firm expands internally by reinvesting past profits or by borrowing, rather than growing through a process of mergers and acquisitions.
- 12.5** Firms have found various ways of demonstrating corporate social responsibility (CSR). For example, premier league football club Southampton runs an outreach programme into local primary schools, providing PE sessions. Other firms may sponsor local sports teams. If you have tackled Exercise 12.3 you may have come across other examples of CSR.

Answers to Exercises and Case studies

Exercise 12.1

- a** To maximise profits the firm must choose output such that $MR = MC$. When price is at P_1 this is at output C . At P_2 profits are maximised at B , and at P_3 , A is the level of output at which $MR = MC$.
- b** At output level C , with price at P_1 , average revenue is above average cost, so the firm makes supernormal profits (profits above the opportunity cost of capital). At output level B , with price at P_2 , the firm finds that average revenue equals average cost, so it makes only normal profit. At output level A , with price at P_3 , the firm finds that average revenue is below average variable cost — the firm is therefore making such a loss that it is better off closing down and leaving the market, even in the short run.

Exercise 12.2

- a** In this case, the owners of the firm are the *principals* and the managers act as the *agents*, running the firm on behalf of the owners.
- b** Here the department store is the *principal*, and the employees undertake work on the store's behalf. John Lewis has tried to address this by making its employees 'partners' in the company.
- c** The customers are now the *principals* and the department store is the *agent*, providing retail services to its customers.
- d** The consumers of electricity are the *principals*, and the electricity supplier is the *agent*, supplying electricity. Notice that it may be difficult to establish effective ways in which the supplier can be held to account if it fails to deliver effective services, as coordinated action may be problematic.
- e** Here the dentist is the *agent*, and the patients the *principals*.

Exercise 12.3

I do not know which large firms you looked at, but I would be surprised if any of them failed to itemise a range of activities in which they engage to demonstrate their commitment to corporate social responsibility.

Case study 12.1

Coke vs Pepsi in India

- a The approach adopted by the firms seems to be aimed more at maximising the volume of sales rather than profits.
- b The strategy seemed to be to maximise sales volumes in order to maximise their market shares. This was seen to be costly in the short run, in the sense that profit margins were being squeezed. However, the managers of the firms seemed to see this as necessary in order to boost sales.
- c By cutting price to such a low level, it was crucial to be able to minimise costs. The firms used a number of ways to try to achieve this. One way was to reduce the weight of the bottles in order to reduce transport costs. Using cheap methods of transport in the rural areas also helped to reduce costs. Reducing the size of bottles for sale was expected to lead to an increase in demand from poor consumers by putting the cola within reach of those on low incomes.
- d It is difficult to evaluate the impact of PepsiCo's record on corporate social responsibility, but it is likely to have an impact on its reputation. This may have helped to counter the bad publicity resulting from the pesticide scare mentioned in the case study, which seems to have affected its market position.
- e The passage does not say anything specific about the firms' long-term objectives. However, one possibility is that each firm hopes to gain a dominant market position that would then enable it to increase its profits in the longer term. It does seem that the market was recovering from a difficult period but was growing rapidly. The firms may therefore have seen it as being important to gain a high market share in this growing market — or at least, not to get left behind the other firm, and therefore find themselves squeezed out of the market when things quietened down later.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 c. $MR = MC$
- 2 a. The divorce between ownership and control
- 3 a. The aim to make enough profit to satisfy the shareholders

B Knowledge and understanding questions

- 4 Maximisation objectives may include:

- Profit maximisation
- Sales revenue maximisation
- Sales volume maximisation
- Growth maximisation
- Utility maximisation
- Long-run profit maximisation

Two maximisation objectives explained	4 marks
One maximisation objective explained AND one maximisation objective identified	3 marks
One maximisation objective explained OR two	2 marks

maximisation objectives identified	
One maximisation objective identified	1 mark

5 Non-maximisation objectives may include:

- Profit satisficing
- Sales revenue satisficing
- Sales volume satisficing
- Growth satisficing
- Utility satisficing
- Long-run profit satisficing
- Social welfare and corporate social responsibility

Two non-maximisation objectives explained	4 marks
One non-maximisation objective explained AND one non-maximisation objective identified	3 marks
One non-maximisation objective explained OR two non-maximisation objectives identified	2 marks
One non-maximisation objective identified	1 mark

6 Factors may include:

- Type of ownership
- Type of product/service
- Motivation of owners
- Competition
- State of the wider economy

Two factors explained	4 marks
One factor explained AND one factor identified	3 marks
One factor explained OR two factors identified	2 marks
One factor identified	1 mark

C Stimulus response question

- 7 a** Profit maximisation is the point where $MC = MR$. It is the objective that seeks to make as much profit as possible for a firm (or to make the smallest loss).

A full explanation	2 marks
A vague or partial explanation	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	3 marks
AO4 Evaluation	3 marks

Knowledge (1 mark) is likely to include:

- Corporate social responsibility (CSR)

Application (1 mark) is likely to include:

- Application of the benefits of focusing on CSR to a business

Analysis (3 marks) is likely to include:

Analysis of the benefits to a firm of focusing on CSR, for example:

- An increase in reputation, which may lead to longer run maximisation objectives
- A competitive advantage over other firms in the market (non-price competition)
- Compliance with (or avoidance of) expected legislation

Evaluation (3 marks) is likely to include:

Evaluation of the benefits to a firm of focusing on CSR, for example:

- Depends upon the competitiveness of the market
- Depends upon the resources available to the firm
- Depends upon the legislation in the market
- Depends upon the actions/objectives of other firms in the market

Evaluation of the costs to a firm of focusing on CSR, for example:

- The costs of CSR
- The objectives of other stakeholders of the firm, such as owners and customers

A judgement of the benefits to a business of focusing on CSR

D Essay question

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AO1 Knowledge	3 marks
AO2 Application	4 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (3 marks) likely to include:

- Profit maximisation
- Other business objectives

Application (4 marks) is likely to include:

- Application to business objectives (may include a graph explaining profit maximisation)

Analysis (6 marks) is likely to include:

Analysis of profit maximisation as a business objective, for example:

- Analysis of the need to maximise profits to maintain shareholder capital within a company
- Analysis of the consequences of not pursuing profit maximisation on a company

Evaluation (7 marks) is likely to include:

Evaluation that profit maximisation may not be the primary objective for a company, for example:

- Shareholders may not have an objective to pursue profits
- Short-run vs long-run profit maximisation

Evaluation that other objectives may be more important than profit maximisation, for example:

- Depends upon the objectives of other stakeholders
- Depends upon the competitiveness of the market
- Depends upon the resources available to the firm
- Depends upon the legislation in the market
- Depends upon the actions/objectives of other firms in the market

A judgement of the extent to which the primary objective of every company must be to maximise profit for the shareholders