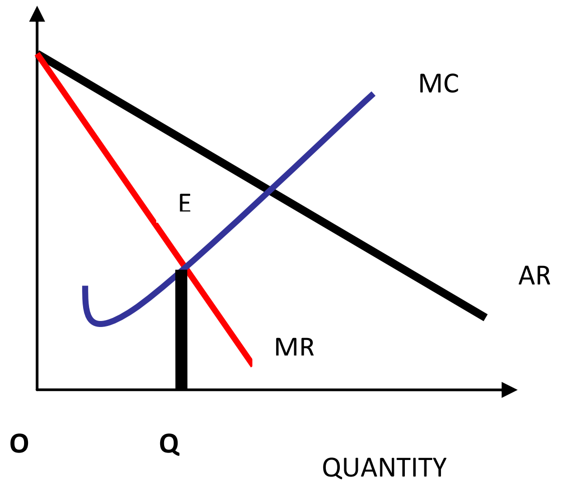
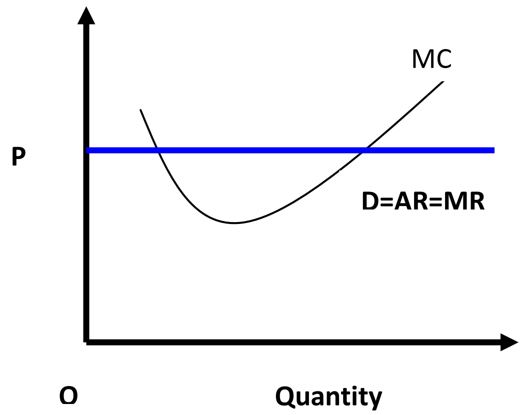
Objectives of a firm

Profit maximization

Traditionally it is the main objective of a firm. According to this a firm prefers to produce at that point where it can make maximum of profit. To gain that level of production a firm may follow to different rules i.e. total revenue, total cost rule and marginal cost marginal revenue rule. According to the total revenue and total cost method a firm produces to that extent where there is a maximum difference between total revenue and total cost. According to marginal cost and marginal revenue rule, a firm produces to that extent where marginal revenue and marginal cost are equal. Before the equilibrium output MR is more than the MC and a firm which wants to maximize its profit wants to earn every profit on each and every unit. It wants to earn maximum profit on the whole.





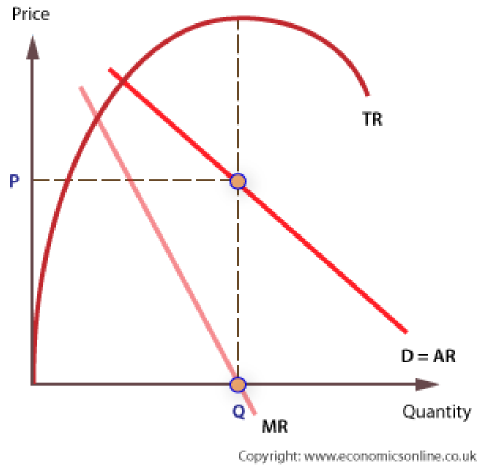
However, in practice it is not possible for a firm to make maximum of the profit in the long run due to following reasons.

Firstly, firms do not make maximum profit because it may attract new firms, hence competition will be increased. Secondly, firms are reluctant to make maximum profit to avoid government watch dogs. Thirdly, it may damage the relationship between stakeholders, such as consumers and workers. Fourthly, it may be possible to the certain scale of production, but it is difficult to calculate MR and MC in mass production. Usually firms work out on their average cost and add on a profit margin to determine the selling price. In some cases management may have some other objectives. It is also not possible, where goods are not divisible by nature. Profit maximization is also not possible in service sector.

Managerial and Behavioural Theories

Sales Revenue Maximization

A firm can maximize its sales revenue by producing up to that extent where MR approaches to zero. A firm is prepared to charge low prices when it wants to increase its market share. This is a price penetration policy. A firm can make abnormal profit if TR is more than TC at the given output. This policy is also chosen when management salaries are linked with the sales. The solution of this conflict of interest is to offer management some shares as a bonus or link their salaries to profit. This policy is also formed by the state when industry experiences growth and a firm want to increase its market share.



Sales Maximization

This policy maximizes sales instead of sales revenue maximization. Theoretically it is possible when a firm produces to that extent where average revenue approaches to zero. In practice a firm may produce up to the breakeven point, where total revenue is equal to the total cost. A higher output implies loss making behaviour. It is possible when a firm may subsidize its loss by using the profit of some other firms. It could be positive in state-owned business organization which has some social objectives. Another possibility may be a firm wants to clear its existing stock at the end of a season or due to an exit from the market, so, to make any recovery.

Satisficing Profit.

According to this policy a firm is determined to make reasonable profit, sufficient to keep on its activities or to satisfy its share holders. It may wants to keep all stakeholders happy. It may spend more on wages or on the improvement of working conditions, which increases cost of production. It may charge low prices to keep its customers happy. This profit may be anywhere between normal profit and positive economic profit.

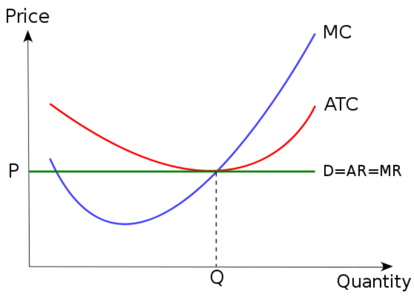
Survival

Mainly it will be the objective of a firm when there is question mark on its existence and the firm finds it difficult to survive. Usually it happens at the early stage of the firm, when existing firms make it difficult to penetrate. Secondly, when trading becomes difficult due to fall in demand for the product or due to bad debts or losing confidence of customer. Thirdly, when there is downturn of the economy and presences of recessionary pressure make it difficult for the firm to survive. Under such condition(s) primary objective is the survival.
Conclusion: The ultimate objective of all business organization is profit maximization. All other objective are formed for the short run by forgoing objective of profit maximization.

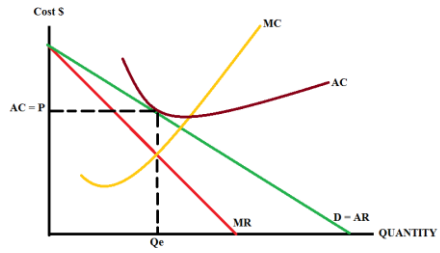
Types of profit

Normal profit

It is the minimum profit which is required to a firm to keep its existence in the long run. At equilibrium output i.e. (where marginal revenue is equal to marginal cost), average revenue is equal to the average cost. At this level of profit 'economic profit' is zero.



Perfect competition

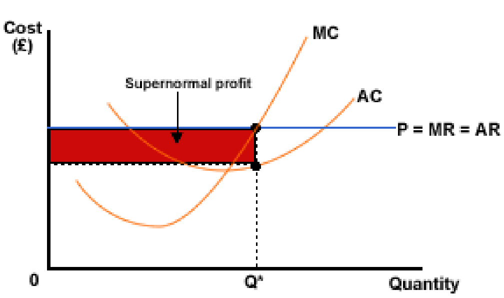


Imperfect competition

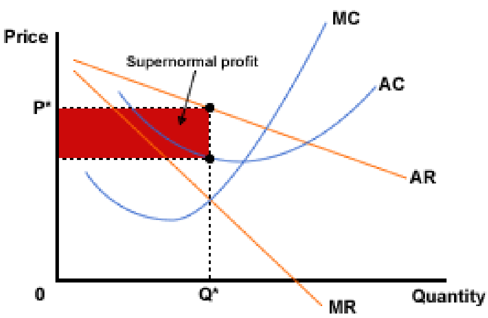
This will be the break- even point for the firm because at this level of output total revenue is equal to the total cost. Usually it is thought that there is no profit for the entrepreneur but actually it takes profit as a reward of a factor of production which is measured as explicit cost.

Abnormal Profit

It is the any profit which in excess of the normal profit. At equilibrium output average revenue exceed average total cost. At this point a firm makes positive economic profit.



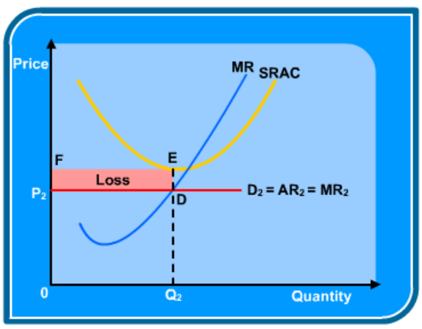
Perfect competition

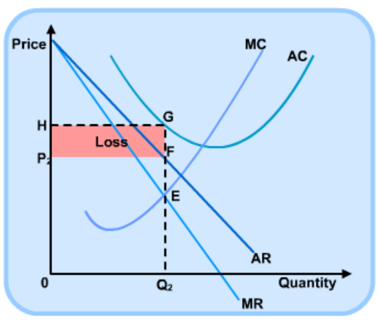


Imperfect competition

Loss/ Subnormal profit with contribution

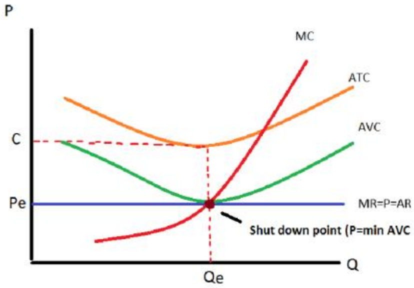
A firm incurs loss if at the equilibrium output its average total cost exceeds its average revenue. At this point economic profit of the firm will be negative. However, it will continue its production unless it meets to its average variable cost. As is shown in the following figures, where average total cost is passing above the average revenue curve and shaded area show the amount of loss at output OQ.

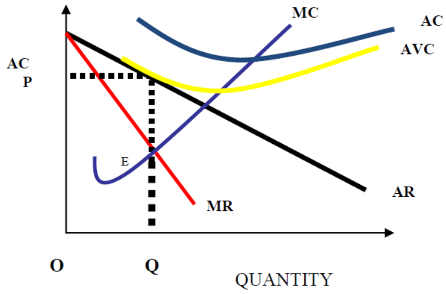




Loss/ subnormal profit without contribution- the shut down point

Price at the shutdown point is the minimum price which is acceptable for a firm to continue its production in the short run but if average revenue is below than the average cost of production, the firm stops production and exit from the market.


P
MC
ATC
AVC
C
Pe
MR=P=AR
Shut down point (P=min AVC
Qe
Q


MC
AC
AVC
AC
P
E
MR
AR
O
Q
QUANTITY