

**Firms**  
Organization of the Firm  
Profit Definitions

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**What is a firm?**

- A firm is a business organization that brings together and coordinates the factors of production for the purpose of supplying goods and services.

Which of the 5 “Big” questions applies to firms?

**Goal of the firm – Maximize profits**

2 ways to classify firms:

1) By industry      2) By legal organization

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**Firms and Legal Organization**

- Legal Organization of firms
  - Sole proprietorship
  - Partnership
  - Corporation

Since we see all three types, there must be advantages to each structure.

75% of all firms are proprietorships, yet 86% of all profits go to corporations.

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### Opportunity Cost and Economic Profit

- Recall that a firm's opportunity cost of production is its best foregone alternative.

In the firm's production decision, they face 2 types of costs:

- Explicit costs – “outlay costs” “accounting costs” – Money used to pay for the use of the factors of production
- Implicit Costs – opportunities foregone but not paid for directly

Where do firms face implicit costs?

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### Implicit Costs

- Where do firms face implicit costs?

- Capital
  - Economic depreciation (≠ accounting depreciation)
    - Change in the market price of capital over a given period
  - Interest
- Owner's resources
  - Normal Profit

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### Normal Profit

- A measure of the implicit costs of owner-supplied resources in a firm over a given period of time (Portion of the firm's cost that is not included in the accounting cost)

Thus we must note the distinction between “Accounting Profit” and “Economic Profit”

Accounting Profit = Total Revenue – explicit costs  
(uses conventional depreciation approach)

Economic Profit = Total Revenue – opportunity costs  
(uses economic depreciation approach)

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