

# *Managerial Economics & Business Strategy*

## **Chapter 1 The Fundamentals of Managerial Economics**



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## **Overview**

### **I. Introduction**

### **II. The Economics of Effective Management**

- Identify Goals and Constraints
- Recognize the Role of Profits
- Five Forces Model
- Understand Incentives
- Understand Markets
- Recognize the Time Value of Money
- Use Marginal Analysis

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# Managerial Economics

- Manager
  - A person who directs resources to achieve a stated goal.
- Economics
  - The science of making decisions in the presence of scarce resources.
- Managerial Economics
  - The study of how to direct scarce resources in the way that most efficiently achieves a managerial goal.  
Use concepts and techniques from economics to make better business decisions. (Increase profits)

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Examples of business decisions (that can be helped using concepts from economics):

1. What price to charge for a product?  
(E.g. what price to charge for a bottle of soda out of a vending machine?)
2. What's the cheapest way to produce a product?  
(E.g. how/where should Motorola produce its latest model of cell phone?)
3. How/how much to advertise?

And thousands more.

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## Identify Goals and Constraints

- Sound decision making involves having well-defined *goals*.
  - Leads to making the “right” decisions.
- In striving to achieve a goal, we often face *constraints*.
  - Constraints are an artifact of scarcity.

Student's Goal: Make a good grade

Student's Constraint: Limited time

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## Economic vs. Accounting Profits

- Accounting Profits (The type on financial statements, the type reported to IRS)
  - Total revenue (sales) minus dollar cost of producing goods or services.
  - Reported on the firm's income statement.
- Economic Profits
  - Total revenue minus total opportunity cost.

Opportunity cost: The next best alternative surrendered when a choice is made. (You buy a ham sandwich for lunch for \$5. Opportunity cost: Can't buy the roast beef sandwich.)

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# Opportunity Cost

- Accounting Costs
  - The explicit costs of the resources needed to produce goods or services.
  - Reported on the firm's income statement.
- Opportunity Cost
  - The cost of the explicit *and* implicit resources that are foregone when a decision is made.
- Economic Profits
  - Total revenue minus total opportunity cost.

Things the business uses that it doesn't pay money for, but which have a good alternate use

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Example: Biff owns and manages an auto repair shop. Last month his revenue was \$100,000. He had these costs (explicit costs):

Labor: \$20,000

Rent: \$5,000

Utilities: \$7,000

Insurance: \$1,000

Parts: \$19,000

In addition: (Implicit Costs)

a) Biff worked 40 hours per week running his shop. If he were not running his own shop, he could have made \$5,000 last month working for someone else.

b) Biff uses his own tools/equipment at the shop. Had he not used his tools himself, he could have rented them for \$2,000 last month.

Biff's Accounting Profits:

$$\$100000 - \$20000 - \$5000 - \$7000 - \$1000 - \$19000 = \$48000.00$$

Biff's Economic Profits: (Accounting profits minus implicit costs)

$$\$48000 - \$5000 - \$2000 = \$41000.00$$

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# Profits as a Signal

## Economic

- Profits signal to resource holders where resources are most highly valued by society.
  - Resources will flow into industries that are most highly valued by society.

E.g. biotechnology companies are very profitable so it is easy for them to raise money, find investors

E.g. U.S. auto companies are unprofitable so it is very hard for them to attract investors (and in fact many investors abandon the business)

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