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Wealth Maximization versus Profit Maximization-The more appropriate Goal

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Abstract- *Financial management pursues two sorts of goals-profit maximization and wealth maximization. One is concerned with earning profits, whereas the other is concerned with adding value. Profit maximization is an inappropriate goal because it's short term in nature and focus more on what earnings are generated rather than value maximization which comply to shareholders wealth maximization. Wealth maximization overcomes all the limitations that profit maximization possesses. In the short term, profit maximization may pursue such action which might be proved harmful in the long run. On the other hand, wealth maximization might not seem beneficial in the short run, but in the long run-this purpose fulfills the goal of shareholders that is add value. So, whenever there is a comparison, profit maximization is inferior to wealth maximization. The focus has been made on this difference throughout the paper.*

Key Words- *Short Term; Long Term; Profit; Value; Wealth; Risk*

1. LITERATURE REVIEW

The firm's decision making are continuous and unavoidable. In order to make them rationally, the firm must have a goal. It is generally agreed in theory that financial goal of a firm should be "Shareholder Wealth Maximization" as reflected in the firm's market value of shares.

Profit maximization as a business objective was a 19 th century criterion when the characteristic feature of the business structure were self-financing, private property and single entrepreneurship. The only aim of the single owner then was to enhance his/her individual wealth and personal power which could easily be satisfied by the profit maximization (Solomon, 1969).

The modern business environment is characterized by limited liability and a divorce between management and ownership. Shareholders and lenders today finance the 8 business firm but it is controlled and directed by professional management. The other important stakeholders of the firm are customers, employees, government and society. In the new business environment profit maximization, therefore, is regarded as unrealistic, difficult, inappropriate and immoral (Robert B., 1960).

Profit maximization as an ultimate objective for the economic welfare of the owners is also criticized due to following limitations:

- It is vague;
- It ignores the timings of returns;
- It ignores risk. (Solomon, 1969)

Shareholder Wealth Maximization means the net present value or a wealth of a course of action is the difference between the present value of its benefits and the present value of its costs.

The objective of Shareholder Wealth Maximization takes care of the questions of timing and the risk of the expected benefits. These problems are handled by considering the Weighted Average Cost of Capital (WACC) while calculating the return (Pandye, 2010).

It was found that Shareholder Value Creation is a good yardstick to measure Corporate Performance (Kakani, Saha and Reddy NSE Research Paper No. 5).

We, thus, realize that the researchers the world over have realized the importance of Wealth Maximization as an objective of every firm. Wealth maximization as represented by Shareholder Value Creation has thus, become objective of all mangers and managements (Pandye, 2010).

However, unlimited profit maximization cannot be defended by any reasonable ethical theory. The idea that corporations should pursue the interests of their shareholders, takes its starkest form in the sentiment expressed by Milton Friedman, that ''the social responsibility of business is to increase its profits'' (Friedman, 1970). Friedman is very clear in stating that it is illegitimate for a corporation to act in a way that is detrimental to shareholder returns. Profit maximization is thus a moral imperative for corporate executives. The interests of groups other than the shareholders should thus only be given weight to the extent that pursuing these interests also benefits the shareholders. For instance the implication of CSR is permissible only if it is insincere i.e. used as an instrument to promote shareholder interests (Bakan, 2004).

2. OBJECTIVE

To find out what are the differences between wealth maximization and profit maximization indicating which one is superior to another.

3. METHODOLOGY OF DATA

Secondary Data has been used along with other online references.

4. INTRODUCTION

Every firm has a predefined goal or an objective. Therefore the most important goal of a financial manager is to increase the owner's economic welfare. Here economics welfare may refer to maximization of profit or maximization of shareholders wealth. Therefore Shareholders wealth maximization (SWM) plays a very crucial role as far as financial goals of a firm are concerned.

A firm's goals may be classified into three, namely:

- Financial goals;
- Non-financial goals;
- Corporate goals.

(a) The financial goals of any profit making organization include:

- Profit maximization;
- Wealth creation/maximization.

(b) The non-financial goals include:

- Environmental care;
- Enhancing ethics in business and finance;
- Employee welfare;
- Corporate social responsibility;
- Good creditor relations;
- Compliance with government regulations;
- Addressing customers' interests.

(c) The corporate goals include:

- Return on investment
- Cash flow
- Enlarging/expanding market share
- Overall growth of the company.
- Quality of the firm's products
- Good industrial relations.

Modern managerial finance theory operates on the assumption that the primary goal of the firm is to maximize the wealth of its stockholders, which translates into maximizing the price of the firm's common stock. The other goals mentioned above also influence a firm's policy but are less important than stock price maximization.

The financial management has come a long way by fluctuating its concentration from traditional approach to modern approach. The modern approach focuses on wealth maximization rather than profit maximization. This gives a longer term horizon for assessment, making way for supportable recital by businesses.

A bigoted person or business is mostly concerned about short term benefits. A short term horizon can fulfill objective of earning profit but may not help in creating wealth. It is because wealth creation needs a longer term horizon Therefore, financial management emphasizes on wealth maximization rather than profit maximization. For a business, it is not necessary that profit should be the only objective; it may concentrate on various other aspects like increasing sales, capturing more market share etc, which will take care of profitability. So, we can say that profit maximization is a subset of wealth and being a subset, it will facilitate wealth creation.

Example: Under wealth maximization, more importance is given to cash flows rather than profitability. As it is said that profit is a relative term, it can be a figure in some currency, it can be in percentage etc. For e.g. a profit of say $10,000 cannot be judged as good or bad for a business, till it is compared with investment, sales etc. Similarly, duration of earning the profit is also important i.e. whether it is earned in short term or long term.

When business managers try to maximize the wealth of their firm, they are actually trying to increase their stock price. As the stock price increases, the individual who holds the stock wealth increases. As the stock price goes up, the value of the firm increases and the net worth of the individual who owns the stock increases.

An obvious question that arises now is that how can we measure wealth. Well, a basic principle is that ultimately wealth maximization should be discovered in increased net worth or value of business. So, to measure the same, value of business is said to be a function of two factors – earnings per share and capitalization rate. And it can be measured by adopting following relation:

Value of business = EPS / Capitalization rate

5. PROFIT MAXIMIZATION

The objective of financial management is profit maximization. It cannot be the sole objective of a company as there is a direct/relationship between risk and profit. If profit maximization is the only goal, then risk factories ignored.

Sometimes, higher the risk, higher is the possibility of profits. Hence, risk has to be balanced with the objective of profit maximization. In addition, a firm has to take into account the social considerations, and normal obligations to the interests of workers, consumers, society, government, as well as ethical trade practices. However, as profit maximization ignores risk and uncertainty and timing of returns, a firm can't solely depend on the objective.

Profit Maximization is the capability of the firm in producing maximum output with the limited input or it uses minimum input for producing stated output. It is termed as the foremost objective of the company.

It has been traditionally recommended that the obvious motive of any business organization is to earn profit, it is essential for the success, survival and growth of the company. Profit is a long term objective, but it has a short term perspective i.e. one financial year. Profit play a vital role in the profit maximization. It can be calculated by deducting total cost from total revenue. Through profit maximization a firm can be able to ascertain the input – output levels, which gives the highest amount of profit. Therefore, the finance officer of an organization should, take his decision in the direction of maximizing profit, although it is not the only objective of the company.

6. WEALTH MAXIMIZATION

The concept of wealth in the context of wealth maximization objective refers to the shareholders' wealth as reflected by the market price of their shares in the share market. Hence, maximization of wealth means maximization of the market price of the equity shares of the company.

Wealth maximization is the ability of a company to increase the market value of its common stock over time. The market value of the firm is based on many factors like their goodwill, sales, services, quality of products, etc.

It is the versatile goal of the company and highly recommended criterion for evaluating the performance of a business organization. This will help the firm to increase their share in the market, attain leadership, maintain consumer satisfaction and many other benefits are also there.

This states that the financial decisions of the firm should be taken in such a manner that will increase the Net Present Worth of the company's profit. The value is based on two factors:

- Rate of Earning per share
- Capitalization Rate

7. DIFFERENCE BETWEEN PROFIT MAXIMIZATION AND WEALTH MAXIMIZATION

Financial Management is concerned with the proper utilization of funds in such a manner that it will increase the value plus earnings of the firm. Wherever funds are involved, financial management is there. There are two paramount objectives of the Financial Management: Profit Maximization and Wealth Maximization.

Profit Maximization as its name signifies, refers that the profit of the firm should be increased while Wealth Maximization, aims at accelerating the worth of the entity. There is always a dispute regarding which one of them the more important. So, in this article you will see the significant differences between Profit Maximization and Wealth Maximization.

Comparison Chart

Basis of comparison	Profit maximization	Wealth maximization
Concept	The main objective of a concern is to earn a larger amount of profit.	The ultimate goal of the concern is to improve the market value of its shares.
Emphasizes on	Achieving short term objectives.	Achieving long term objectives.
Consideration of Risks and Uncertainty	No	Yes
Advantage	Acts as a yardstick for computing the operational efficiency of the entity.	Gaining a large market share.
Recognition of Time Pattern of Returns	No	Yes

The major differences between profit maximization and wealth maximization are:

- The process through which the company is capable of increasing is earning capacity is known as Profit Maximization. On the other hand, the ability of the company in increasing the value of its stock in the market is known as wealth maximization.
- Profit maximization is a short term objective of the firm while long term objective is Wealth Maximization.
- Profit Maximization ignores risk and uncertainty. Unlike Wealth Maximization, which considers both.
- Profit Maximization avoids time value of money, but Wealth Maximization recognizes it.
- Profit Maximization is necessary for the survival and growth of the enterprise. Conversely, Wealth Maximization accelerates the growth rate of the enterprise and aims at attaining maximum market share of the economy.

Expounding on Financial Goals -Profit and Wealth Maximization.

Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at maximizing the profit of the concern.

Profit maximization consists of the following important features:

- Profit maximization is also called cashing per share maximization. It leads to maximize the business operation for profit maximization;
- Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern;
- Profit is the parameter of measuring the efficiency of the business concern. So, it shows the entire position of the business concern;
- Profit maximization objectives help to reduce the risk of the business;

What is wrong with Profit Maximization?

Profit maximization refers to how much dollar profit the company makes. It is a short term approach and a narrow-minded person or business is mostly concerned about short term benefits.

But a short term horizon can fulfill objective of earning profit but may not help in creating wealth. It is because wealth creation needs a longer term; therefore financial management emphasizes on wealth maximization rather than profit maximization.

For a business, it is not necessary that profit should be the only objective; it may concentrate on various other aspects like increasing sales, capturing more market share, return on capital etc, which will take care of profitability. So, we can say that profit maximization is asubset of wealth and being a subset, it will facilitate wealth creation.

Constrains of Profit Maximization-

- It is a short term approach
- It ignores the timing of returns, cash flows, and risk
- Profit max method could not discuss on market share, high sales, and greater stability and so on.
- It could not consider the social responsibility that is one of the most important objectives of many firms.

Favorable Arguments for Profit Maximization
The following important points are in support of the profit maximization objectives of the business concern:
• Main aim is earning profit;
• Profit is the parameter of the business operation;
• Profit reduces risk of the business concern;
• Profit is the main source of finance;
• Profitability meets the social needs also;
Unfavorable Arguments for Profit Maximization
The following important points are against the objectives of profit maximization:
• May leads to exploiting workers and consumers;
• Creates immoral practices such as corrupt practice, unfair trade practice, etc;
• This objective leads to inequalities among the stakeholders such as customers, suppliers, public shareholders, etc.

Expounding Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is a universally accepted concept in the field of business.

Favorable Arguments for Wealth Maximization
• Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders
• Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern
• Wealth maximization considers both time and risk of the business concern
• Wealth maximization provides efficient allocation of resources
• It ensures the economic interest of the society
• Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities
• Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization
• Wealth maximization creates ownership-management controversy
• Management alone enjoy certain benefits
• The ultimate aim of the wealth maximization objectives is to maximize the profit. Wealth maximization can be activated only with the help of the profitable position of the business concern.

8. CONCLUSION

Profit is the basic requirement of any entity otherwise it will lose its capital and cannot be able to survive in the long run. But, risk is always associated with profit or in the simple language profit is directly proportional to risk and the higher the profit, the higher will be the risk involved with it. So, for gaining the larger amount of profit a finance manager has to take such decision which will give a boost to the profitability of the enterprise. In the short run, risk factor can be neglected, but in the long run the entity cannot ignore the uncertainty. Shareholders are investing their money in the company with the hope of getting good returns and if they see that nothing is done to increase their wealth. They will invest somewhere else. If the finance manager takes reckless decisions regarding risky investments, shareholders will lose their trust in that company and sale out the shares which will adversely effect on the reputation of the company and ultimately the market value of the shares will fall.

Profit maximization objective consists of certain drawback also:

- It is vague: In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern
- Ignores the time value of money: Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period
- Ignores risk: Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.
- When a firm applies profit maximization, it is basically saying that its primary focus is on profits, and it will use its resources solely to get the biggest profits possible, regardless of the consequences or the risk involved. Profit maximization is a generally short-term concept. Application usually lasts less than one year, although some companies employ this strategy exclusively, constantly jumping on the next big trend.

Therefore, it can be said that for day to day decision making, Profit Maximization can be taken into consideration as a sole parameter but when it comes to decisions which will directly affect the interest of the shareholders, then Wealth Maximization should be exclusively considered.

In another way, wealth maximization is a strategic target of the entity, while the profit maximizations is a tactical one . the profit maximization always concern with the operational plans and the wealth maximization always concern with top managements plans .

Summary

There are two forms of financial management; the traditional profit maximization approach and the more modern wealth maximization approach.

- Profit maximization is short term approach and it refers to how much money the company makes. But Wealth maximization is a long term approach and it refers the value of the company.
- Profit maximization is a subset of wealth.
- Profit max ignores timing, cash flows, and risk, but in wealth maximizing those are the key decisions variables.
- Maximization of wealth approach believes that money has time value.
- Profit maximization is short term strategy and focuses on making profits in the short term, which may result in taking courses of action that could be harmful in the long term.
- Wealth maximization takes on a different, modern approach where the organization will focus on maximizing wealth in the long run as opposed to making short term gains.

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