Profit maximization in financial management pdf

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G.H. Lawson (Professor, Business Finance, Manchester Business School) ACCEPTING that companies wish to maximize profits in some sense, this article first considers three major problems which together constitute the main core of financial management. Thereafter, some aspects of investment and financing decisions are treated in greater detail. Lawson, G.H. (1969), "Profit maximization via financial management", Management Decision, Vol. 3 No. 4, pp. 6-12. : MCB UP Ltd Copyright © 1969, MCB UP Limited The objective of a Financial Management is to design a method of operating the Internal Investment and financing of a firm. The two widely used approaches are Profit Maximization and Wealth maximization. Profit maximization: Profit maximization is considered as the goal of financial management. In this approach actions that increase the profits should be undertaken and the actions that decrease the profits are avoided. The term 'profit' is used in two senses. In one sense it is used as an owner oriented. In this concept it refers to the amount and share of national Income that is paid to the owners of business. The second way is an operational concept i.e. profitability. It is the traditional and narrow approach, which aims at, maximizes the profit of the concern. The 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. and hence Profit maximization objectives help to reduce the risk of the business. Its main aim is to earn profit. In this criteria Profit is the main parameter of business operation. It reduces the risk of business concern. In this criteria profit is the main source of finance and profitability meets the social needs. Some of the unfavorable arguments of profit maximizations are that it leads to exploiting workers and consumers. It also creates immoral practices such as corrupt practice, unfair trade practice, etc. It also creates inequalities among the stake holders such as customers, suppliers, public shareholders, etc. Some of the drawbacks of profit maximizations are In Profit Maximization, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern. For example, profit may be long term or short term. It may be total profit or rate of profit. It may be net profit before tax or net profit after tax. It may be return on total capital employed or total assets or shareholders equity and so on. It 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. When the profitability is worked out the bigger the better principle is adopted as the decision is based on the total benefits received over the working life of the asset, Irrespective of when they were received. It ignores the quality aspects of benefits which are associated with the financial course of action. The term 'quality' means the degree of certainty associated with which benefits can be expected. Therefore, the more certain the expected return, the higher the quality of benefits. As against this, the more uncertain or fluctuating the expected benefits, the lower the quality of benefits. It 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. 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. It removes technical disadvantages of the profit 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. This concept considers both time and risk of business concern. This criteria provides efficient allocation of resources and it also ensures the economic interest of the society. The wealth maximization criterion is based on cash flows generated and not on accounting profit. The computation of cash inflows and cash outflows is precise. Wealth maximization can be activated only with the help of the profitable position of the business concern. So The goal of maximizing the value of the stock avoids the problems associated with the different goals we discussed above.in a simple language a good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it. So the financial manager best serves the owners of the business by identifying goods and services that add value to the firm because they are desired and valued in the free marketplace. So it is a long term concept based on the cash flows rather than profits and hence there can be a situation where a business makes losses every year but there are cash profits because of heavy depreciation which indirectly suggests heavy investment in fixed assets and that is the real wealth and it takes into account the time value of money and so is universally accepted. Profit maximization is the capability of a business or company to earn the maximum profit with low cost which is considered as the chief target of any business and also one of the objectives of financial management. According to financial management, profit maximization is the approach or process which increases the profit or Earnings per Share (EPS) of the business. More specifically, profit maximization to optimum levels is the focal point of investment or financing decisions. "Profit maximization may be the 'end' but the means to achieve this end, is what matters, and that distinguishes a company in the corporate world and the market." – Henrietta Newton Martin Benefits of Profit Maximization: Profit maximization has the following benefits: The foundation of the profit maximization theory is profit and profit is a must for the economic existence of any company or business. Profit determines the standard of performance of any business or company. When a business is unable to make profits it fails to fulfill its chief target and causes a risk to its existence. Economic and Social Well-being: Profit maximization theory indirectly plays a role in economic and social well-being. When a business makes a profit, it utilizes and allocates resources properly which in turn results in the payments for capital, fixed assets, labor and organization. In this way, economic and social welfare is performed. Drawbacks of Profit Maximization: The Vagueness of the Profit Concept: The concept of profit is indefinite because different people may have a different idea about profit, such as profit can be EPS, gross profit, net profit, profit before interest and tax, profit ratio, etc. Particularly, no definite profit-maximizing rule or method exists in reality. Does Not Consider Time Value of Money: The profit maximization theory only states that higher the profit better the performance of the business. The theory only considers profit without considering the time value of money. The concept of the time value of money tells that a certain unit of money today will not be equal to the same unit of money a year later. Does Not Consider the Risk: Any business decision only considering profit maximization model ignores the involved risk factor which may be harmful to the existence of the business in the long-run. Because if the business is incapable of handling the higher risk, it's survival will be in question. Does Not Consider the Quality: Intangible benefits e.g. image, technological advancements, quality, etc. are not considered in the profit maximization approach which is considered as one of the biggest drawbacks. These intangible assets have a mentionable role in creating value for the business which cannot be ignored. Profit maximization theory is based on a traditional viewpoint but the modern business and financial concept value wealth maximization much more than profit maximization. How to Achieve Profit Maximization: The following two steps can be applied to achieve profit maximization. 1. Increasing Sales-revenue: Sales-revenue can be increased in the following profit-maximizing ways. Increasing sales quality by applying better marketing strategies, quality improvement, a thorough market study to assess that from which segment more money is coming to the business and concentrate in making more sales from those products or services. You can also borrow the best marketing strategy from your competitors, or similar businesses. Insisting existing customers to buy extra services or products. Diversification by selling a wider variety of products or services. Revising pricing of products or services to achieve increased sales-revenue. You can charge a higher price for your product or service if its better in quality. Temporarily you can lose a few clients but according to researchers, people prefer a quality product or services even by paying a little high. Motivating employees can also increase sales-revenue because satisfied employees will perform better and help to produce better products and services which will help the company to earn a profit. Better performance appraisal techniques such as announcing employee of the month, promotion, increment, etc. or going out for picnic, lunch, arranging cultural programs, etc. can motivate employees. Educating all customers both existing and potential for your product or service by tv or radio or newspaper advertisements, digital marketing or email-marketing or social-media marketing, publishing and distributing leaflets, posters, banners, etc. 2. Cost-cutting: Cost-cutting can be done in the following profit-maximizing manners. Analysis of the full expenditure of money to different sectors. Negotiate with suppliers for cheaper prices especially when buying in large quantities. Manufacturing process should be more efficient to reduce wastage. Technologies which saves time and expands production should be applied. Looking for a new cost-effective energy supplier because a large amount of money is spent on the energy sector. Outsourcing: A business cannot do all the tasks by itself or a small business cannot hire a talented people on a full-time basis at a higher Outsourcing can save a lot of money here. Full-time employees will be engaged in revenue-generating projects and simple tasks can be done by outsourcing or through freelancers. Business people can maximize profit by following the above steps keeping time value of money, the risk and quality factor in consideration.

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