

Goal of a Firm

The objective of a firm is to achieve a definite goal. Mainly, there are two types of goal of a firm such as:

1. Profit maximization.
2. Wealth maximization.

Profit Maximization

Normally a firm or companies try to fulfill the needs of a society by providing the daily necessities. The main goal behind of this process is to achieve profit and maximize the profit. In a competitive market, we have to make profit by providing the cheap goods and services for the society. In this modern business world, word "profit" has the following meanings.

According to owner oriented concept, the amount the owner gets from the firm is profit. On the other hand, operational concept says that after producing quality goods with effectively and efficiently, the amount what the producer gets is profit. This is called profitability. In this modern world profitability is the main goal of a company.

In the economic theory, the behavior of a firm is analyzed in terms of profit maximization. Profit maximization means maximizing the income of firms. While profit maximization is the main goal of a firm, the firm will go for either produces maximum output for a given amount of output or uses minimum input for producing a given output. Thus, the underlying logic of efficient allocation of resources under the competitive market conditions and profit is considered as the most appropriate measure of a firm's performance.

According to C.P Jones, "Profit maximization is maximization of a firm's net income."

According to Weston & Brigham, "The maximization of the firm's net income is called profit maximization."

According to Khan & Jain, "The profit maximization criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented to the maximization of profit or EPS."

From the above discussion we can say that profit maximization means maximizing the income of firms.

Rationale behind profit maximization as the goal of a firm

Any business organization runs their business for attaining a specific goal. The goals of the organization may be different from each organization. Such as, some have to establish their objective to achieve profit but firms which want to perform their business activities for long period of time their prime goal is maximize the wealth of the organization. The following three reasons are behind profit maximization is the goal of a firm:

Profit is the yardstick to measure efficiency: If a firm or the owners of a firm can achieve satisfactory profit by investing their capital to provide social demand then we can say that economic condition of the firm is developing. So, profit is the best yardstick to measure the firm's efficiency for maximizing the firm's economic position.

Proper utilization of resources: It is possible to maximize profit by proper utilization of resources. So, if we want to maximize profit, we have to utilize the assets perfectly.

Social welfare: Social welfare is possible by profit maximization because these way investors get profit and consumer's gets their desirable products or services. Therefore, if owners get more profits then he/she expand the business which ultimately create employment opportunity and play a role in country's economic development.

Criticism of profit maximization / problems of profit maximization

Ambiguity or Vague concept: The precise meaning of the profit maximization objective is unclear. The definition of the term "profit" is ambiguous, whether it is a short-term or long-term profit, before or after tax, net profit or total profit, it is not gives clear concept. Different people define it differently, one calculate profit on capital other on total assets. So, we can clearly say that profit maximization should not be the goal of a firm and the financial manager.

Timing of profit and time value of money is ignored: The profit maximization objective does not make a distinction between returns received in different time period. It gives no consideration to the tome value of money and it value benefits received today and benefits received after a period as the same. For this reason, profit maximization should not be the goal of a firm.

It ignores risk: Profit Maximization also ignores risk. The chance that actual outcomes may differ from those expected investment. The investor is not quite clear whether they get profit from a particular investment in future. So, profit maximization is risk ignoring concept.

Wealth Maximization

The objective of the shareholder's wealth maximization is an appropriate and operationally feasible criterion to choose among the alternative financial action. It provides an unambiguous measure of what financial management should seek to maximize in making investment and financing decisions on behalf of shareholders.

Wealth maximization means to maximize the price of shares of that firm or to maximize the net present price. The net present value (NPV) of a course of action is the difference between the present value of its benefits and the present value of its costs. A financial action that has a positive NPV creates wealth for shareholders and therefore is desirable. So, the wealth will be maximized if this criterion is followed in making financial decision. The net present value or wealth can be defined more explicitly in the following way:

$$V=W=NPV= [A_1/ (1+k)^1 +A_2/ (1+k)^2+..... +An / (1+k)^n] -C$$

Where, as A1, A2, A3.....A3 refers to net cash benefit , k is the appropriate discount rate, C is the primary capital and w is the net present value or wealth. By using this formula, the price of the share or the wealth of particular company will increase as much as the project with positive net present value of any company increases. Also we can say, maximization of wealth means maximization of value of the firm.

$$\text{Valuation of the company} = \frac{\text{After tax net income}}{\text{Expected rate of return}}$$

According to I.M Panday, "Wealth maximization means maximizing the net present value (wealth) of a course of action to shareholders."

According to C.P. Jones, "The goal of the firm should be to maximize stockholder wealth, which is accomplished by maximizing the current stock price."

According to Khan & Jain, "Wealth maximization implies the maximization of the market price of share."

Rationale behind the wealth maximization as the ultimate goals

Clear concept: The concept of wealth maximization is a clear concept. It is not based on the concept of profit, which is full of ambiguity and un-clarity. Rather it is based on the concept of cash flow, which clear and well understood.

Time value of money is considered: The concept of wealth maximization takes into consideration the value of money. In fact, to determine the value of share, a potential investor discounts the future inflows of the firm to be invested.

Risk of the firm considered: This concept also considers the risk of the firm. The risk of the firm is measured by calculating the profitability of the availability of the future inflows. The uncertainties relating to the future inflows are eventually adjusted with a risk premium.

Focus on market price of share: The welfare of the owner (investor) is ensured only if value of the firm is increased. The concept of wealth maximization emphasizes on the value of the share, which is the indicator of the value of the firm.

Distinguish between Profit maximization and wealth maximization

There is always a conflict regarding which one is more important between the two. So, the significant differences between Profit Maximization and Wealth Maximization:

Profit maximization	Wealth maximization
Profit maximization means maximizing the profit of the firms.	Wealth maximization implies the maximization of the market price of share.
Profit Maximization emphasizes on short term goals.	Wealth Maximization emphasizes on long term goals.
It ignores the time value of money.	It considers the time value of money.
It ignores the risk and uncertainty.	It considers the risk and uncertainty.
It does not consider the cash flows.	It considers the cash flows.
It is not a clear concept.	It is a clear concept.