International Journal of Research in Finance and Marketing (IJRFM)
Available online at : http://euroasiapub.org/current.php?title=IJRFM
Vol. 7 Issue 6, June - 2017, pp. 217~219
ISSN(o): 2231-5985 | Impact Factor: 6.397 | Thomson Reuters Researcher ID: L-5236-2015

"Profit Maximisation as an objective of a firm - A Robust Perspective".

Zubair Ahmad Khan
Institution: The Business School, University of Kashmir
Designation: Research Scholar

Abstract

Several objectives have been proffered for decision making in a business concern, the prominent ones being Profit Maximization, Shareholders Wealth Maximization, Societal Value Maximization and Personal Reward Maximization. Among all the objectives, profit maximization holds a central position so far as their application is concerned. Small and medium enterprises particularly use this criterion for making decisions owing to its simple conceptual underpinnings and use and also due to the fact that profit is important for the sustainability of any business. Profit is also considered as a measurement standard for the viability of a business model. The operating logic behind this approach is efficiency. Despite the prominence of this criterion, it suffers from limitations like vagueness of the term, 'Profit', ignorance of quality, timing and risk of benefits. The article provides a fundamental platform for a future in depth analysis of the said objective in contemporary business context.

Keywords: Objective, Business, Profit Maximization, Decision Making, Efficiency.

The Profit Maximization approach proposes that the prime objective of a business concern should be to maximize its profits. Every decision should therefore be gauged by the profit criteria only and should be taken only if it ultimately leads to the maximization of profits.

A business with sound profits is perceived as efficient both in terms of operation as well as investment. Conferring to this approach, more profits a business makes better will be its brand image, as profit is treated as a barometer of efficiency of a business. A business with adequate profits will be able to retain enough to support itself in economic breakdowns or financial distress. Hence profit acts as a cushion for business against such financial shocks. Investors also prefer to invest their surplus in businesses with sound profits, as they anticipate regular income in the short run and capital appreciation in the long. So, firms with better profits are easily able to raise funds from the market and at lesser cost too, as investors are ready to invest, predominantly due to the perception of less risk in investing there and thus leaving less concern for its creditworthiness. This is due to the fact that an adequately profitable business has the capacity and is usually inclined to pay its obligations on time and hence creditworthy.

Profit Maximization assumes 'Perfect Competition' like market conditions. The operating logic and backbone of this approach is 'efficiency'. Put in simple terms, 'efficiency' refers to minimizing inputs and maximizing outputs.

Literally, 'Profit' refers to excess of sales over cost. For a business to maximize profits either the sales value should increase or the cost value should decrease, technically marginal revenue equalling marginal cost. If we see the possibility of increasing sales value, it can be obtained by either increasing the selling price of products (maximizing margin) or by increasing the total sales (sales maximization). So far as increasing 'selling price' decision is concerned, such strategy will not work in favour of the firm in perfect competition as availability of substitutes at lesser price will induce the customer to switch their preference. Hence, such strategy will result in loss of revenue for the business. Now, if we analyse the possibility of increasing the sales revenue, it cannot be achieved directly unless more and more customers are not motivated to purchase the products which the business offers. As per the 'Profit Maximization', approach at this stage 'efficiency' plays its part. When a business attains efficiency in operations, it is able to optimize resources, i.e. minimize inputs and maximize outputs. Wastages and unnecessary costs are cut down. This results in decreasing input costs for the firm. Now the firm can afford to offer the same product at lesser price without affecting profit margin. This strategy of offering the product at lesser price in perfect competition culminates in sales maximization. Hence in perfect competition, the customers will now switch their preference for such product as it will provide them with a substitute at lesser price. Naturally this will lead to increase in sales revenue and ultimately lead to 'Profit Maximization'.

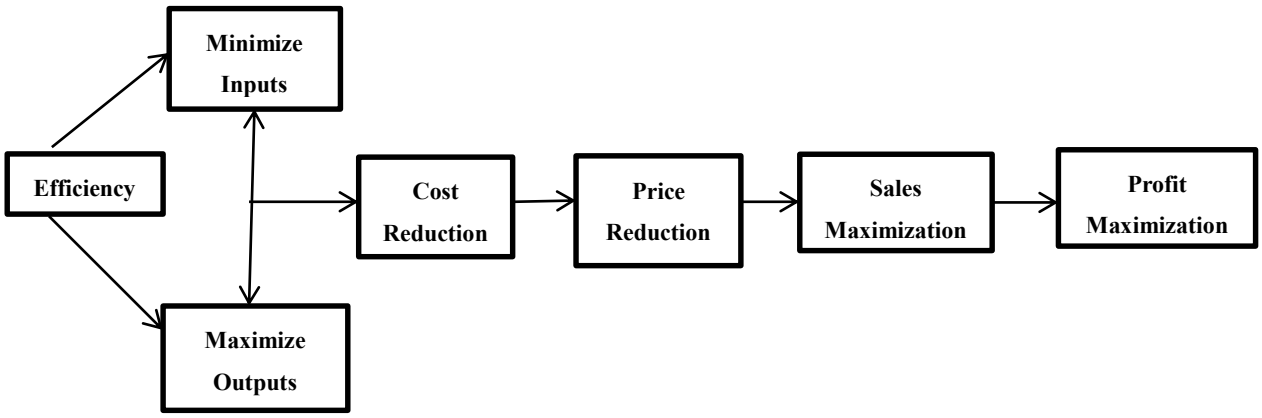

Figure: Operating logic of profit maximization concept

It was Adam Smith who first put forward the idea that individual business firms, each acting for its own benefit could, indirectly on an aggregate, benefit society. More than 200 years ago he wrote in his theory, "The theory of invisible hand":

> "(The businessman) by directing . . . industry in such a manner as its produce may be of greatest value . . . intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not a part of his intention. . . . pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it".

Adam Smith explicitly supports the profit maximization approach by his 'theory of invisible hand'. The primary implications in favour of society in his theory refer to optimal use of resources and lesser price of products available for the consumers in pursuit of maximizing profits for the business.

The profit maximization approach has been criticized on many grounds, some common critiques include:

Profits maximization approach causes wastage of resources as the businessmen in the voracity of maximizing profits try to produce more and more, leading to unnecessary production and hence wastage of resources.

Definition of word 'Profit' in profit maximization is vague. It is not explicitly mentioned which profit to maximize as there are numerous types of profit in a business.

This approach ignores the risk associated with the profits. Businesses usually prefer lesser but surer profits to higher, uncertain or risky profits.

Profit maximization ignores timing of returns, i.e. ignores 'Time Value of Money'.

In this approach magnitude of benefits is given more importance as compared to the quality of benefits.

Despite the above cited limitations, and also the availability of other technical alternative approaches, profit maximization criteria is still used for making decisions on a large scale particularly by small scale businesses, primarily due to its simplicity to understand and use and economy in terms of time and cost.

References

Anthony, Robert B. (1960). "The Trouble with Profit Maximization." Harvard Business Review, 38:126-34.

Landsg, S (2002). Price Theory and Applications (5th edition). South-Western.

Smith, Adam. (1937). The Wealth of Nations. Modern Library. 423. (Quoted in Solomon and Pringle. 1978. Introduction to Financial Management.)