Limitations of Profit Maximization

The profit maximization criterion is criticized on the following grounds:

- It ignores the quality aspects of benefits associated with business.
- It is ambiguity – vague; it means different to different people – may be pre-tax or post-tax.
- It ignores the difference in time and value of money. The fact that a rupee received today is more valuable than the rupee received later is ignored.
- It may ignore the social welfare sometimes.
- It gives effect to change in organization structure.

Wealth Maximization

This is also known as net present worth maximization approach. It takes into consideration the time value of money. Its operational features satisfy all the three requirements of a suitable operational objective of financial courses of action i.e. quality of benefits, timing of benefits and exactness.

The wealth maximization approach can be more explicitly defined in the following ways:

$$W = \left(\frac{A_1}{(1+K)^1} + \frac{A_2}{(1+K)^2} + \frac{A_3}{(1+K)^3} + \ldots\ldots \frac{A_n}{(1+K)^n} \right) - C$$

where,

$A_1, A_2 \ldots\ldots A_n$ = Streams of benefits expected

C = Cash outlay (or) Cost of action

K = Discount rate

W = Net present worth

The objective of wealth maximization helps to resolve two most troublesome problems attached with the flow of benefits. There is consideration of time value of money. The problem is handled by selecting an appropriate rate of discount and using the rate of discount the expected flow of future benefits.

Profit Maximization *Versus* Wealth Maximization

- ✓ Profit cannot be ascertained well in advance to express the probability of return as future is uncertain.
- ✓ The term ‘profit’ is vague and has not been explained clearly what it means
- ✓ The vagueness is not present in wealth maximization goal as the concept of wealth is very clear.
- ✓ It represents value of benefits minus the cost of investment
- ✓ The firm’s goal cannot be to maximize profits but to attain a certain level of profit holding certain amount of shares.
- ✓ The firms should try to ‘satisfy’ rather than to ‘maximize’.
- ✓ There must be balance between expected return and risk. There exist great risk to recognize such a balance and wealth maximization is brought into the analysis.