

# Is profit maximization consistent with wealth maximization finance essay



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The objective of the firm is to make profits by meeting the needs of stakeholders. Generally, ceteris paribus, the objective of the firm is to maximize its ultimate value through profit maximization, while incurring the lowest costs. Basically, the ultimate objective of the firm is to acquire maximum profits and wealth for its shareholders. It is important to note that, the value of the firm is signified by the existing market prices of the corporation's common stock market. In this respect, the maximization of the shareholder's wealth is enhanced by the acquiring of maximum profits at the lowest level of expenditure. As it has been revealed, there exists a very strong co-relation between profit maximization and wealth maximization, where each of them forms part of the objective of the firm. In this case, the total earnings do not represent the ultimate value of the corporation but the profits accrued from the employed resources. Generally, any firm would be run towards acquirement of high profits which represent its actual wealth for its shareholders (Westerfield 23-75). Firms exist to meet the needs of stakeholders and to provide an efficient way of producing in a non-price environment. Firms exist to meet the needs of the populace in an efficient and a sustainable manner.

## **2. Is profit maximization consistent with wealth maximization? Why or why not?**

Profit maximization is not consistent with wealth maximization. It has some drawbacks and cannot be used for effective evaluation on the performance of the firm.

On the other hand, wealth maximization, which is also known as the net present worth of a firm can be used to evaluate the performance of the firm.

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Wealth maximization is seen as more comprehensive and superior than profit maximization. Profit maximization deals with minimizing short term profits and is not forward-looking. Again, the profit maximization objective does not factor in time value of money considerations. Therefore wealth maximization is superior because it is a long term objective and considers the time value of money by discounting cash flows to the present time. Additionally, wealth maximization considers uncertainty by discounting at the required rate of return and considering the other stakeholders of the firm.

## **Profit Maximization**

## **Wealth Maximization**

It is not clear on when the profit is counted as profit – whether this should be before or after tax. Another uncertainty involves the long-term or short-term profit. Short term profit can be foregone by avoiding some expenditure but in the long run, these expenditures have to be paid for. Therefore long term profit has to be considered, and not short term profit.

Wealth maximization shows the present value of benefits minus the cost of the investment.

Profit maximization does not factor in risk. Different projects have different degrees of risk of future earnings. A project with fluctuating earnings is not the same as one with certainty earnings. By not looking at the risk factor of projects, profit maximization cannot be used for the operational objective of the firm.

Risk is considered in wealth maximization as the discounted rate used to determine the present value of future cash flows factors in the risk.

Lastly, profit maximization does not factor in the time value of money. A dollar spent today is not equivalent to the same dollar spent tomorrow. Cash drawn from a project in different years is considered the same, which is not realistic.

Wealth maximization considers the time value of money as the cash drawn from a project in different years are not the same. The discounted rate that determines the present value of future cash flows shows both risk and time.

### **3. Describe the three main decisions in Corporate Finance**

The three main decisions in Corporate Finance are:

#### **(a) Investment Decision (Allocation)**

There are two key questions that are looked into when a firm wants to make an investment.

What is a good investment? The firm looks at the various investment options in the market, for instance real estate investments or stocks investments.

The risk involved and the returns to be gained.

Where will the firm's resources be invested? Here, it is important that the firm does not put all their resources into one basket. For instance, the firm may decide to invest a certain percentage of their resources in either stocks or real estate.

Further, the pattern and the level of investment would be determined in which each investment plan is evaluated on the risks involved together with its ultimate returns expected. It is important to note that, the pattern of investment would still be an important factor to consider since each individual plan of investment would be accompanied with its benefits and risks.

### **(b) Financing Decision**

Primarily, the financial decision considers where the firm would raise the funds for these investments. Will the firm use the shareholder's/owners funds or borrow from the bank? The mix of equity and debt is what is considered in the financing decision. When, where and how to acquire the money to meet the firm's needs.

In this case, the finance managers ought to decide on the financing strategy of the firm, in which the evaluation of various sources of finance to cater for the running of firms' activities would be made. Basically, each source of capital would be evaluated with the level of interests to be paid for the amount of money acquired.

Capital Structure - Modigliani y Miller (1958) - how much should a firm borrow?

### **(c) Dividend Decision**

The dividend decision is concerned with how much of the firm profits should be given to the shareholders, and how much of it should be reinvested. A dividend policy should be determined. the dividends decision would be made

in order to determine the amount of the profits to be ploughed back into the firm depending on the amount of profits made (Westerfield 23-75).

Dividend policy - Modigliani y Miller (1961) - another irrelevance proposition

Another finance decision worth mentioning is the liquidity decision, whereby a firm looks at how to manage working capital and its components.

#### **4. What is a “ hurdle rate”? Why is it important?**

Also known as the cut off rate, the hurdle rate is the minimum expected return a firm will consider in accepting investment decisions. If a firm's proposal own internal rate of return,  $r$ , is greater than the minimum rate of return,  $k$ , then it is acceptable. The  $r$  is internal to the project while the  $k$  (hurdle rate) is external to the project. The hurdle rate is used to make a decision based on the Internal Rate of Return (IRR) method which takes into account the cash flows occurring at different times and adjusts them according to the time value of money.

The hurdle rate is very important as it enhances the planning of the investment patterns and levels since the firm establishes investment patterns which would the highest possible minimum returns. Basically, hurdle rate determines on how to acquire investment capitals as those capital sources with very high interest rates would not be economical to choose. The hurdle rate represents the internal rate of return of any investment since the finance manager would be in a position to decide on various allocation within the firm, on the basis of the hurdle rate set in the firm.

## **5. What are the main components of a discount rate?**

The discount rate is the rate at which money values are discounted at various times, within an investment period. Discount rates are comprised of three main components which include the interest rate of money, level of inflation and risk premiums involved. More specifically, the interests rates at which money capital is allocated comprises of the discount rates in any projected investment project. Specifically, the interest rate of money is the return got from delaying consumption. More so, the level of inflation in the country determines the value of money. This is because the level of inflation determines the purchasing power of money, which represents the ultimate value of money. Lastly, risks involved in the investment venture are another important component of the discount rate. Generally, highly risky business ventures would always have high discount rates. In this respect therefore, it would be very important for the finance manager to determine the discount rates to be used in the calculation of the cash-flows in the business venture (Westerfield 23-75).

## **6. Define the “ Efficient Market Hypothesis”**

Efficient market hypothesis is an investment assumption that postulates that, financial markets are efficient in providing information about the market returns from any form of investment. More specifically, in efficient market hypothesis, investors are controlled by the existing market conditions in terms of the financial stability or conditions of the money market. It is important to note that, inflation level and economic conditions of the country determines a lot on the efficiency of the financial information given by the market in terms of money interests and capital returns. In this regard,

investors need to evaluate their investment ventures on the basis of the existing conditions or the information got from the financial markets which are considered to be the accurate in providing financial information (Higgins 12-43).

## **7. Describe the three forms of efficiency**

The 3 forms of efficiency are the strong-form efficiency, semi-strong efficiency and weak-form efficiency. In the form weak-form efficiency, all the information in the past stock-price fluctuations is totally shown in the present prices. This means that, the information provided is to compare the current price levels with the past prices.

The semi-strong form involves the reflection of all publicly available data about the current prices in the market. In this form, there is some information that is withheld among the investors but most of the information is availed to the general public.

On the other hand, the strong-form of efficiency in the market reflects all relevant information in the money market, whether withheld or publicly available. Here, the investors have the opportunity to explore in-depth all the trends of the money market in order to make reliable information about their investment (Westerfield 23-75).



## **8. What is the difference between Technical Analysis and Fundamental Analysis?**

### **Technical Analysis**

### **Fundamental Analysis**

Technical analysis is an appraisal strategy in the money market that looks at the price movements in the market in order to establish their security levels for investors to decide on how to choose their investment plans.

Fundamental analysis on the other hand refers to the economic factors facing the money market in which each of the statement is presented in financial statements as opposed to technical analysis which uses using charts.

Technical analysts usually use information found in charts and graphs to determine the financial worth of the company.

Generally, fundamental analysis determines the ultimate value of the company by examining its financial statements like balance sheets and income statements among others.

technical analysts use shorter periods of time in their determination of the worth of the company

Fundamental analysis involves a long period of time in which the financial worth of the business ought to be devised using subsequent fiscal periods but not one period

Information derived from (Higgins 12-43)

## 9. Do you believe markets are efficient?

I believe that markets are not as efficient as economists reveal that they are. The major reason is because various market conditions are controlled by external factors which they have no control over them. In this respect, it would be difficult to determine the efficiency of the market or to predict the conditions of the market on considerations that, these external factors are also controlled by other forces. For instance, markets are often controlled by inflation rates and interest rates which are factors beyond the control of the market itself. On this consideration, it would be very important for any investor to note the unpredictability of the markets in order to make appropriate investments. There is no perfect information in the market. It is on this basis therefore that I believe that markets are not efficient at all (Westerfield 23-75).

## 10. Efficient Market Hypothesis

Which of the following statements are true if the efficient market hypothesis holds?

- a. It implies that future events can be forecast with perfect accuracy.
- b. It implies that prices reflect all available information.
- c. It implies that security prices change for no discernible reason.
- d. It implies that prices do not fluctuate.

If efficient market hypothesis holds, the future events can be forecasted with ease. This is because, all the information concerning stocks in the stock

market would be well presented in a more accurate way, to reflect on the subsequent trends expected in the future in the market. In this respect therefore, if the efficient market hypothesis holds, it would enhance easiness in predicting any future trends of investment as the information in the market would be quite reliable. More so, if this hypothesis holds, the information provided would be reflecting all the prices that would be available in the market. This is because; every price presented in the market information would greatly imply a predictive nature of the prices in the future markets. Generally, if the efficient market hypothesis holds, then the above two statements would be true (Higgins 12-43).