FACTORS AFFECTING
THE CHOICE OF
PROFIT MAXIMIZATION
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I. ABSTRACT

For centuries, economists have been carried out thousands of research on how firms would set their objectives under various circumstances. For many firms, profit is a major concern because it could directly affect the existence of the firms not only in the short-run, but also the long-run.

However, there are still a huge amount of firms which choose to maximize their sales and value, or satisfactory profit instead of “pure” profit. Many empirical and theoretical studies have shown the reasons for this decision, such as the various goals of a firm in the short-run, especially firms entering the new market for the first time or establishing a new product; the structure of the firms if they are managerial-controlled; etc.

Therefore, our group found out that the topic “Factors affecting the choice of profit maximization” is an interesting and challenging for economic students like us to carry out this literature review. We wanted to have a close look into the reasons why firm would want to maximize profit instead of revenue like many other firms nowadays.

This paper is a collection of studies which have been done by most economists who supported the neo classical economics school such as Friedman (1970), Solomon (1969), Mackey (2007), etc.

We hope through this research our group members will be able to gain more knowledge about firms objectives and researching experience which could help us in our future study and research.

We also would like to send a huge thank to Mrs. Hong Vinh, our teacher of the Business Economics course for giving us not only the valuable lectures, but also the chance to do this useful research.
II. INTRODUCTION

Profit of a firm is the financial benefit that is defined by total revenue minus total cost. It will be at the maximum point when the marginal revenue is equal to marginal cost. In the real world, it is a complex work to determine the marginal cost and marginal revenue, so that it is a real obstacle for any firms which choose to maximize their profit.

The theory of the firm is one of the microeconomic concept, which founded in the neoclassical economics, states that firms (including businesses and corporations) exist and make decisions to maximize their profit. In that theory, the behavior of a particular firm is said to be driven by profit maximization.

There were two empirical studies in the UK, which were carried out by Shipley (1981) and Hornby (1995). Shipley (1981) studied a sample of 728 UK firms using a questionnaire. He found that 47.7% of respondents said they tried to maximize profits and the remainder to make satisfactory profits. In response to a second question about the relative importance of profit maximization compared with other objectives, only 26.1% said it was of overriding importance. Further analysis led Shipley to conclude that only 15.9% of responding firms were “true” profit maximizers. This conclusion was reached by considering only those who said that they tried to maximize profit and that profit was of overriding importance. Hornby (1995) found on the basis of a sample of 74 Scottish companies that 24.7% of respondents could be regarded as “true” profit maximizers. These studies also showed that firms tend to have a range of goals rather than a single goal. Profit, therefore, is an important objective but not to the exclusion of other objectives.

Although there are many criticisms about the neoclassical theory of firm which express that firms often seek to maximize the size of firms and market share rather than profit, profit maximization is still a major goal of many business organizations for several reasons, such as:

- Profits enable greater wages and dividends for the stakeholders (shareholders, managers, employees) of the company.
- Profit can be used to finance investment in expanding the company
Profit provides a fall back for difficult times

Profits also provides a measure of the efficiency and effectiveness of management policies.

Therefore, when assuming that firms have no incentives to maximize revenue instead of profits, we clarified factors affecting the choice of profit maximization into two main groups, which are the external factors and internal factors. All of the external factors will be related to the relationship that firms have with the outside parties such as their stockholders, stakeholders, competitors and the government. On the other hand, the internal factors will consider about the structure of the firms, their other objectives, advertising and social media.
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1. External factors

1.1. Relationship with other parties

Profit maximization is always the crucial objective of each firm. However, in order to maintain the highest point of profit, firms have to deal with various problems including the relationship with other parties who involve in the production progress.

1.1.1. Stockholders

There may be some significant trade-offs, which is associated with stockholders that firms need to consider before making the last decision. According to Solomon, he argued that, to satisfy the owners or shareholders, the only way is to maximize profit because it would help increase the assets as well as afford the investment that they spend before. The firm's decision making are continuous and unavoidable. In order to make them rationally, the firm must have a goal. It is generally agreed in theory that financial goal of a firm should be "Shareholder Wealth Maximization" as reflected in the firm's market value of shares. Profit maximization as a business objective was a 19th century criterion when the characteristic feature of the business structure was self-financing, private property and single entrepreneurship. The only aim of the single owner then was to enhance his/her individual wealth and personal power which could easily be satisfied by the profit maximization (Solomon, 1969).

However, The book published in 2009 by Frank Fabozzi and Pamela Peterson provides arguments to prove uselessness of the accounting profit in the owner’s wealth maximization process and focus the attention on recently developed tools for measuring shareholder value: economic and market value-added. The authors do not neglect agency problem, discussing the costs of agency relationship and the ways to motivate managers to create shareholder value in the long-term. Manipulation of accounting data and social responsibility of the operating entity are also mentioned in this context. Frank and Pamela thought that instead of provide
shareholders with highest profit, firms should focus on how to increase the values in long-term for them.

1.1.2. Stakeholders

When discussing about the influence of stakeholder on the possibility of making profit maximization, Alan Griffiths and Stuart Wall assumed that profit maximization is still an important key and encouraged due to it provides rewards for stakeholders (wage increases for employees, price reductions or improved products for the consumers.) (2005)

However, in fact, to achieve the maximum profit, firms are usually unable to balance with employees justify. Ballinger’s report hit Nike at a crucial moment; from 1988 to 1993 Nike’s profits had tripled, but following the various sweatshop-like scandals, Nike’s share prices fell dramatically and sales lagged (Shaw, 1999). The outrage by labor activists, universities, and individual consumers led to crippling reputational damage and by 1998 CEO Phil Knight was forced to admit that “The Nike product has become synonymous with slave wages, forced overtime, and arbitrary abuse …I truly believe the American consumer 6 doesn’t want to buy products under abusive conditions” (Nisen, 2013)

In another aspect, corporate social responsibility is considered as a factor affecting the choice of profit maximization. First, it seems to be a huge obstacle to the aim of maximizing profit. However, many forms of corporate social responsibility may not actually decrease the present value of future cash flows. In fact some responsible behavior might actually improve the firm’s future cash flows and thus be consistent with wealth-maximizing interest of stockholders (Mackey, et al., 2007).

Furthermore, multiple decades of research on corporate social performance and corporate financial performance have shown that corporate well-doing has a positive effect on a company’s profitability (Van der Laan, Van Ees, and Van Witteloostuijn, 2007).
Even from the neo-classical economic point of view, put forward by Friedman (2009), a well-known researcher in CSR area, the only one social responsibility for a business is to utilize its resources and activities to increase companies’ profit. It suggests that the social responsibility of a firm is maximizing the profits, and the overall aim of business managers is to maximize the profit return in order to satisfy the expectations from firm’s shareholders, people who own the firm (Friedman, 1970, cited in Kolstad, 2007; Kolstad, 2007; Pava & Krausz, 1996).

A meta-analysis on CSR and its link to profits won the famed socially responsible investing, Moskowitz Prize in 2004. The study, "Corporate Social and Financial Performance: A Meta-Analysis," was compiled by researchers Marc Orlitzky, Frank L. Schmidt and Sara L. Rynes. It yielded encouraging data suggesting a positive link between CSR and increased profits.

1.1.3. Competitors

In different kind of market, firms will face different competitors. Each firm has to think about the reaction of its competitors to adjust the objectives to survive in the markets.

It is assumed under this view that competition and cooperation are interconnected, and competition will force business to be more cooperative. Hence, virtues and values of doing good and ethical business, such as through friendship, trust, loyalty and cooperation were encouraged in order to survive the competitive market and maximize profit (Klein, 2003).

In classical markets such as monopoly, monopolistic competition and oligopoly, firms decide to set up barriers to deter new competitors by the will of increase in their profits (Varian 2006). Varian may refer to the competition among the old firms and the new entrants as well as the competitors of current companies in term of maximizing profit. If there are more and more new entrants, this situation will be worse for firm because they get less profit (Trefor Jones).


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Merge and acquisition is another threat that firms may pay attention to when maximizing their profits. The competitors or even investors may be interested in firms that gain high profit because they also want that profit to belong to them.

Value theory views a firm as an economic unit whose objective is the maximization of profits or, more generally, the maximization of the present value of the firm. The traditional theory of firm postulates that only those firms which maximize corporate performance will survive and those that do not will either be taken over or eliminated (Alchian, 1958). Alchian idea shows more clearly about the problems of the level of profit that firm may public not too high or too low.

With firms striving to survive in the competitive business environment, mergers and acquisitions (M&A) are among the most efficient strategies for companies to grow and for driving shareholder value. In recent years, mergers have gained momentum due to liberalisation of the capital market and globalisation of competition (Mishra & Goel, 2005).

As Mishra argued above, because M&A trend has been more popular nowadays, so if a firm does not focus on this trend, it may be taken over without any notifications.

1.2. The government

Beside the relationship with other parties, the country regulation and tax policies also affect the profit maximization goal of the firms.

1.2.1. Government regulations

It is obvious that firms have to follow the regulations and laws to have the right to run a business. If the firms break the rules, they may reach the aim of profit maximization earlier; nevertheless, they are less likely to survive for a long period.

The theory that regulations affect profit had been carried out for a long time. However, it was only in 1970 that the real statement of the theory was stated openly to the public by Friedman (1970), as he mentioned “In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to
conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.”

This statement by Friedman (1970) also marked the shift of the theory perspective, in which profit maximization could only be the ultimate goal so long as the law and ethical custom allows it to do so.

In 1996, Hanks also illustrated this idea through his research: Rules and regulations have changed dramatically for the last few decades. In United States, for example, the Court of Law has adopted a view that corporate directors and officers have a fiduciary duty to maximize the long-run interest of the corporate stockholders (Hanks, 1996).

1.2.2. Tax

Tax paying is obliged for every firm; therefore, tax has a significant effect on profitability aim. In 1979, based on the model of Miller and Modigliani, economists Peles and Sarnat conducted a study on the example of the change in tax law in the UK, which measured how tax affects the financial structure of the company. The study noted that these tax changes had a conspicuous impact on the funding policies of companies. Prior to 1966, British companies have been subjected to income tax. A differentiated tax was introduced on dividend as profits distributed were subjected to both income taxes and the income. This movement of tax legislation provided an incentive to reinvest corporate profits leading to deleveraging of the company.

Tax impact on the financial structure of the company is surprised and more recent studies (Wu and Yue, 2009), which examined such as adjust their capital structure of listed companies in China, in response to increasing the rate of profit.

2. Internal factors

Besides the effects from external factors such as CSR, government policies, firms with the aim of maximizing the profit also need to take a serious care of
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internal factors. Size, age and other elements of themselves may also cause the problems that prevent firms from their original objective related to profit.

2.1. Firm structure

2.1.1. Firm size

Most of the studies measuring the effect of firm size on profitability indicated a positive direction between firm size and profitability. The majority of these studies have used total assets, total sales or number of employees as firm size indicators.

The very first study researching the effect of firm size on profitability has been carried on by Simon (1962). However, he was not able to find a statistically significant relation between profitability and firm size. Five years later, Hall and Weiss (1967) have found a positive relation between firm size and profitability in the study they carried on over Fortune 500 firms. On the contrary, Shepherd (1972) has found a negative relation between firm size and profitability.

Akbas and Karaduman (2012) have studied the effect of firm size on profitability on the firms operating in manufacturing sector. Results of the study showed that firm size has a positive effect on profitability. Banchuenvijit (2012) studied factors affecting performances of the firms operating in Vietnam. A positive relation has been found between total sales and profitability of the firms but on the contrary a negative relation has been found between profitability and total assets.

2.1.2. Firm age

Studies predicting how a firm’s profitability is affected by its age can be divided into three main categories. One stream of research suggests that older firms have better financial performance because they are more experienced and enjoy the benefits of “learning by doing” (Coad et al. 2013, Vassilakis 2008). Moreover, younger firms are prone to “liabilities of newness” which refer to a number of poorly understood factors leading to higher failure rates (Stinchcombe 1965).

A second stream of literature demonstrates the view that older firms enjoy better performance and suggests that there might be “selection effects” which arise
when less productive firms are forced to exit the business leading to higher average productivity in the cohort even if the productivity levels of the individual firms do not change over time (Jovanovic 1982).

A third stream of research, however, suggests that aging can have a negative impact on firms’ financial performance due to “inertia effects” leading firms to become inflexible and have difficulties in fitting the rapidly changing business environment in which they operate (Barron et al. 1994).

Some studies investigated age-profitability relationship for Turkish firms. These studies employed relatively small samples and short time periods. The study by Basti et al. (2011) employed panel data covering the period 2003-2006 from a sample of 160 listed firms in Turkey. Results from random effects model showed a positive relationship between age and profitability measures including return on assets, return on equity and basic earning power. On the contrary, Dogan (2013) found a negative relation between firm age and return on assets after running a multiple regression on data from 200 listed companies between the years 2008-2011.

As is clear from the brief review of literature, both theoretical postulates and empirical evidence on age-profitability relationship generated conflicting results which are highly dependent on the countries and periods under consideration as well as on the estimation methodologies employed. This suggests that further empirical evidence on the issue is warranted.

2.2. Productivity

Many studies show that more productive firms are more profitable than their less productive competitors and this effect grows with increasing persistence at high productivity levels. Stierwald (2009) finds his Productivity Persistence variable is significant and positive on Firm Profits.

An interaction term between Productivity and Productivity Persistence is shown to be significant in determining Firm Profits (Stierwald 2009). This further
reinforces that persistent firms with high productivity levels will receive higher profits.

It has also been shown that Lagged Productivity is an important determinant of Firm Profits (Demsetz 1973 and Stierwald 2009). Specifically, Demsetz (1973) argues that with increased Productivity a firm is able to realize lower average costs of production, higher product quality, and a higher output quantity produced.

2.3. Advertising and Social Media

Advertising Expenditures is an important determinant of Firm Profits. Specifically, Hurdle (1974) indicated that advertising has become a means of product differentiation, thus encourages customers to buy more of the specifically advertised product. These ads help build brand identity, increase sales, and capture a higher percentage of the market share which leads to higher profitability.

Advertising Expenses is measured by the cost of advertising media, which includes radio, television, periodicals, as well as promotional expenses, which is then divided by the Net Assets of the firm. The summary statistics show that the average Advertising Expenses have gone down significantly for the time period 2005-2013. This can be explained by platforms, such as Social Media, which allow these firms free means of Advertising. As firms’ adopt these free techniques of marketing and advertising they are able to cut down on their Advertising Expenses.

Due to Social Media’s recent integration into the business world, not many studies have been written on its role on business profits. However, there are a comprehensive number of articles that discuss the positive relationship between Social Media and firms’ financial performance.

Social Media’s complex networks and global reach has provided it means to enhance business performance on many levels. This emergence of Social Media has allowed companies to sell more of their products, which in turn increases their revenues and profits (Shih 2009). Social Media’s wide reaching capacity gives it the ability to create new opportunities for the company involved, by reaching further markets. This technology has evolved from simply connecting friends to now an
important business platform for reaching new potential customers, which may potentially raise their firm size (Shih 2009).

According to Nielsen (2010), Social Media users worldwide have grown from 244 million in 2010 to 315 million just a year later. All of these online users are potential customers as they are now connected into the network through which businesses are able to communicate with them. This transformative technology is allowing business to be done further and further in the marketplace, as companies are able to get in touch with customers all over the world, as well as receive ideas from these remote places (Rodriguez, Petersen, & Krishnan 2012).

Firms are also able to use Social Media in researching other businesses to do business with, and how to incorporate their products into their business. For example, Forrester Research conducted a study in which they surveyed over 1,200 technology executives on their Social Media usage in relation to their buying behavior (Rodriguez, Petersen, and Krishnan 2012). They find that over 75% of these individuals utilize Social Media in order to research and obtain information of specific product or services that they are interested in. Again, this information can help reducing transaction costs and making research more efficient, which is in turn making these companies more productive and more profitable (Rodriguez, Petersen, and Krishnan 2012).

2.4. Technological advances

Recent IT advances have a significant positive impact on profitability. A study of Massachusetts Institute of Technology used data from more than 400 global companies from 1998 to 2003 to research information about this problem. (March 2012 issue of MIS Quarterly). Further studies from this research also suggest that as industries become more competitive, the effect of technology on profitability increases.

They found something very surprising: Investment in technology has a greater impact on a company’s profits than comparable spending on either advertising or R&D. They also notice, however, that there was significantly more variability in the effects of technology investments than in investments in
advertising or R&D. Perhaps the reason is that it involves in novel technologies and especially IT investments that can offer more room for creativity and innovation. Most businesses may already know how to manage advertising and R&D to their best advantage, but only some have mastered managing IT.

IT investment can be used to enhance productivity and reduce costs, or can be used to increase sales growth through customer satisfaction and customer retention strategies. In general, investing in IT was more effective in improving profitability by increasing revenue than by decreasing operating expenses. In fact, IT investment has a marked positive effect on revenue growth; for example, a $1 increase in IT expenditures per employee resulted in a $12.22 increase in sales per employee according to MIT’s research. However, the effect of an increase in IT expenditures on reducing overall operating expenses was negligible in this research.
IV. CONCLUSION

Profit maximization is a major decision for any firms because it can determine the firms’ survival on the market. And that decision is made based on many factors which come from both inside and outside of the firms.

Although there are many criticisms which said that profit maximization is not an important objective anymore, we believe that research about factors affecting the choice of profit maximization still plays an important role of firm behavior studies.

All of the factors we choose to mention above is considered as some main significant factors which can actually affect the choice of profit maximization. Unfortunately, due to the limitation in time and database, as well as the lack of experience, our study is definitely uncompleted. We hope by self-study and the support of time, we will be able to gain more knowledge in business economics field.
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