

Shareholder wealth  
maximization should  
always be the  
preferred objective of  
a fir...



**ASSIGN  
BUSTER**

A financial management system is the methodology and software that an organization uses to oversee and govern its income, expenses, and assets with the objective of maximizing profits and ensuring sustainability. It is concerned with the procurement and use of funds with an aim to use business funds in such a way that the firm's value and earnings are maximized. It also provides a frame work for selecting a proper course of action and deciding a viable commercial strategy which helps to maximize the owner's economic welfare. Financial management Concerns the acquisition, financing, and management of assets with some overall goal in mind. Assets that can no longer be economically justified may need to be reduced, eliminated, or replaced. It requires the existence of some objective or goal, because judgment as to whether or not a financial decision is efficient must be made in light of some standard. Although various objectives are possible, we assume that the goal of the firm is to maximize the wealth of the firm's present owners.

Shares of common stock give evidence of ownership in a corporation.

Shareholder wealth is represented by the market price per share of the firm's common stock, which, in turn, is a reflection of the firm's investment, financing, and asset management decisions. The idea is that the success of a business decision should be judged by the effect that it ultimately has on share price. Frequently, profit maximization is offered as the proper objective of the firm. However, under this goal a manager could continue to show profit increases by merely issuing stock and using the proceeds to invest in Treasury bills. For most firms, this would result in a decrease in each owner's share of profits – that is, earnings per share would fall. Maximizing earnings

per share, therefore, is often advocated as an improved version of profit maximization.

## SHAREHOLDER

A shareholder is any person, company, or other institutions that owns at least one share in a company, also called “ stockholder”. They have the potential to profit if the company does well, but that comes with the potential to lose if the company does poorly.

## SHAREHOLDER WEALTH MAXIMIZATION

Shareholder wealth maximization is the idea behind trying to drive a stock’s price up. The shareholders are the actual owners of the company, so by driving the price up the company become’s worth more than just the value of its assets. The sum becomes greater than the value of its parts, it therefore becomes worth more to keep the business running than it would be to sell off the parts. The shareholder invests money in a business expecting some kind of economic return. Returns have two flavours: dividends and increasing share prices. In order to pay dividends the company must generate cash. The company’s ability to generate cash can be expressed by the financial figures EBITDA (earnings before interest, tax, depreciation and amortization) and EPS (earnings per share). In order to have share prices increase the company must invest money in cash generating assets and activities like new production plants, product development or marketing activities. Value is only created when the benefits of the investments is bigger than the costs of the investments. If a shareholder invests her money in a company and gains no return, the money is better invested elsewhere.

The more money you invest, the higher value the more cash generated, the higher share prices, payouts of dividends and higher shareholders' value. Thus the maximization matter is actually a question of competing for the investors' money. Wealth maximization of the shareholder is the appropriate objective of an enterprise this is because it is a long term benefit compared to the other objectives, when the firm maximizes the shareholder's wealth, the individual shareholder can use this wealth to maximize his individual utility, meaning that by maximizing shareholder's wealth the firm is operating consistently towards maximizing shareholder's utility. A shareholder's current wealth in the firm is the product of the number of shares owned, multiplied with the current stock price per share. This objective helps in increasing the value of shares in the market, the share's market price serves as a performance index of its progress. It also indicates how well management is doing on behalf of the shareholder. However, the maximization of the market price of the shares should be in the long run. Every financial decision should be based on cost-benefit analysis. If the benefit is more than the cost, the decision will help in maximizing the wealth of the shareholder.

#### PROFIT MAXIMIZATION

Why are business firms not seeking profit rather than an increase in share price? One reason is that profit maximization does not take the concept of risk and reward into account like shareholder maximization does. The goal of profit maximization is, at best a short-term goal of financial management. Profit is a measure of efficiency of a business enterprise, its earning is the main aim of every economic activity and a business being an economic

institution must earn profit to cover its costs and provide funds for growth. No business can survive without earning profit, it also serves as a protection against risks which cannot be ensured. The accumulated profits enable a business to face risks like fall in prices, competition from other units, adverse government policies etc. Thus, profit maximization is considered as an objective of business, because it is only with adequate profit maximization that shareholder wealth can be created, so it is safe to say that profit maximization gives birth or is the mother of shareholder wealth maximization.

The following arguments are advanced in favour of profit maximization as an objective of business: When profit-earning is the aim of business then profit maximization should be the obvious objective. Profitability is a barometer for measuring efficiency and economic prosperity of a business enterprise. Economic and business conditions do not remain same at all times. There may be adverse business conditions like recession, depression, severe competition etc. A business will be able to survive under unfavorable situation, only if it has some past earnings to rely upon. Therefore, a business should try to earn more and more when situation is favorable. Profits are the main sources of finance for the growth of a business. So, a business should aim at maximization of profits for enabling its growth and development. Profitability is essential for fulfilling social goals also. A firm by pursuing the objective of profit maximization also maximizes socio-economic welfare. Some other important objectives of a firm include:

Achieving a target market share: This is a part of market analysis that helps indicate how well a firm is doing in the market place compared to its

<https://assignbuster.com/shareholder-wealth-maximization-should-always-be-the-preferred-objective-of-a-firm-essay-sample/>

competitors, it may be inform of improved profitability, survival chances or status. Increasing market share is an important business objective used to measure a business performance because it is less dependent upon macro environmental variables such as the state of the economy or changes in tax policy. Survival: There are circumstances where the major objectives of the firm becomes survival, this mainly occurs when certain economic or market shock forces the managers to occupy their minds solely on short-term issues that would help in ensuring the continuance of the business. National Objectives: Every business whether operating on a small or large scale must have an obligation towards its nation also. It should help in achieving national goals, such as promoting social justice, increasing value added goods for exports, finding out better and cheaper substitutes for imports and helping in increasing exports for building the foreign exchange reserves to meet the import bills.

THE DIFFERENCES BETWEEN SHAREHOLDER WEALTH MAXIMIZATION & PROFIT MAXIMIZATION: Shareholders are different in nature, in terms of their knowledge and business orientation. Most of them are myopic and are highly concerned about immediate benefits. They, therefore, aim at profit maximization. However, others are rational and future-oriented. They aim at wealth maximization, increasing an entity's scope through larger markets share, greater stability and higher sales. Though different, both perspectives are beneficial to an entity. Profit maximization can be seen as a subset of wealth maximization since in the process of creating wealth, profits must be made. Horizon for Assessment

The wealth maximization goal focuses on longer term horizon, this is because it aims at accumulating wealth for the long-run success of an entity. It also gives priority to the creation of value, since it is a function of all long-term yields to the stakeholders. Profit maximization is short-term horizon. It does not focus on creating wealth. It deals with at the moment demands and actualizations. Emphasis on Time and Revenue

Wealth maximization goal highly focuses on cash flow over time. It focuses on the present values of inflows and outflows. One of its components is that money has time value and therefore, can sacrifice today's profits for tomorrow's super profits and future success. While profit maximization considers today's revenues therefore not deliberating on the element's time or risk in the profits. Management and Shareholders Difference

Shareholders, being the owners of an entity, will focus on the wealth maximization goal. They are more risk averse and would take the risks to strain for the long-term success of their entity. They would sacrifice current revenues to reinvest for the future wealth maximization. Management, on the other hand, highly focuses on the present-day revenues of an entity. They prefer profit maximization goals that are concerned with their earnings. Value

Wealth maximization goal is the value of an entity expressed in terms of the market value of its common stock, i. e., the current market trading price per share times the number of common shares outstanding. Profit maximization measures the value of an entity in terms of the currency profits that it

makes. It assumes that the yield of highest value is making as much as possible.

## CRITICISM

However, profit maximization objective has been criticized on many grounds.

They are: A firm pursuing the objective of profit maximization starts exploiting workers and the consumers. Hence, it is immoral and leads to a number of corrupt practices. It is also argued that profit maximization should be the objective in the conditions of perfect competition and in the wake of imperfect competition today, it cannot be the legitimate objective of a firm.

One has to reconcile the conflicting interests of all the parties connected with the firm. Thus, profit maximization as an objective of financial management has been considered inadequate. Even as an operational criterion for maximizing owner's economic welfare, profit maximization has been rejected because of the following drawbacks; The term ' profit' is vague and it cannot be precisely defined. It means different things for different people.

Should we consider short-term profits or long-term profits? Does it mean total profits or earnings per share? Even if, we take the meaning of profits as earnings per share and maximize the earnings per share, it does not necessarily mean increase in the market value of share and the owner's economic welfare. Profit maximization objective ignores the time value of money and does not consider the magnitude and timing of earnings. It treats all earnings as equal when they occur in different periods. It ignores the fact that cash received today is more important than the same amount of cash received after, three years. It does not take into consideration the risk of the prospective earnings stream. Some projects are more risky than other. The <https://assignbuster.com/shareholder-wealth-maximization-should-always-be-the-preferred-objective-of-a-firm-essay-sample/>



effect of dividend policy on the market price of shares is also not considered in the objective of profit maximization.

Whereas the shareholder wealth maximization objective has also been criticized mainly on the following accounts; It being a prescriptive idea. The objective is not descriptive of what the firms actually do. The objective of shareholder wealth maximization is not necessarily socially desirable. There is some controversy as to whether the objective is to maximize the shareholders wealth or the wealth of the firm which includes other financial claimholders such as debenture holders, preferred shareholders, etc. The objective of shareholder wealth maximization may also face difficulties when ownership and management are separated as is the case in most of the large corporate form of organizations. In spite of all the criticism, we are of the opinion that shareholder wealth maximization is the most appropriate objective of a firm and the side costs in the form of conflicts between the shareholders and debenture holders, firm and society and shareholders and managers can be minimized Implications of Wealth maximization.

There is a rationale in applying wealth maximizing policy as an operating financial management policy. It serves the interests of suppliers of loaned capital, employees, management and society. Besides shareholders, there are short-term and long-term suppliers of funds who have financial interests in the concern. Short-term lenders are primarily interested in liquidity position so that they get their payments in time. The long-term lenders get a fixed rate of interest from the earnings and also have a priority over shareholders in return of their funds. Wealth maximization objective not only serves shareholder's interests by increasing the value of holdings but <https://assignbuster.com/shareholder-wealth-maximization-should-always-be-the-preferred-objective-of-a-firm-essay-sample/>

ensures security to lenders also. The economic interest of society is served if various resources are put to economical and efficient use.

## CONCLUSION

Maximizing shareholder wealth should always be the preferred objective of a firm because shareholder wealth maximization is seen as the desirable goal not only from the shareholders' perspective, but also as for the society, it has also been proven that in a firm's pursuit of shareholder wealth maximization, the maximization of society's wealth is also actualized. Extant theoretical and empirical research in financial economics also generally accept shareholder wealth maximization as the normative and ideal goal on which all business decisions should be based. Shareholder wealth maximization is good for not only the shareholders and but also the society because the shareholders' wealth comes from wealth created by the firm after fully compensating everyone involved and the society for all the resources used.

## REFERENCE

Intermediate Financial Management; 10th edition; Eugene F. Brigham & Philip T. Davies; 2010 Brealey and Myers (2003),  
Brigham and Ehrhardt (2002),  
Moyer, McGuigan and Kretlow (2003),  
Jensen (2001),  
Daphne (2009).  
Kwasi Poku (2011).