

Problems with profit maximization strategy finance essay



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Shareholder Value is a financial term which is the final measure to see whether the company is successful in enriching its shareholders or not. We have tried to find the difference between shareholder and the owner wealth and have concluded that shareholder wealth is the supreme point of contention for any organization as in the long term it will benefit both owner and shareholder. Hence, both of them will be content. We first look at why shareholder value maximization should be the primary goal of any organization. Then, we look why there is divergence of the organization with the objective of shareholder wealth maximization. Then, we looked at various agency problems that come due to this divergence. Then, we gave strategies on how managers can increase shareholder wealth. At the end, we concluded with the new concept of stakeholder wealth maximization and explained its utility.

Who owns any organization which is listed in share market, obviously, the Shareholders. These are those individuals who have bought stocks of the company which shows their ownership of the company. Even if business is a person firm, he is the shareholder. If the Business is big, the board of directors are made up of people who own the right by owning the majority of shares. Since, the shareholder own the company, they are entitled to maximum value generation from the money they have invested (Ahlstrom 2010, pp 11-24).

In old times, the traditional approach of companies was to maximize the owner's profit, but there were multiple limitations like:-

Any firm has multiple targets other than maximizing shareholder wealth.

These can be like achieving higher market share, huge sales growth, more stable market position. The traditional approach didn't consider all of these issues.

Shareholder Wealth Maximization has multiple things to be looked into like -

Short term, Medium term and Long term Shareholder Wealth Maximization

Shareholder Wealth Maximization over a period of time.

The traditional approach lost out to these points.

Social Responsibility needs to become the most important aim of any organization. Big Organizations need to give back society in lieu of the resources that they take from them. These big organizations need to devote something out of the profits that they earn. The traditional approach didn't take in account this (Smith 2003, pp 52-76).

Modern approach puts more emphasis on Shareholder Wealth Maximization rather than owner profit maximization. This includes increasing the Earnings per share of every shareholder so that their net worth is maximized. Wealth increase is equal to what gross present worth is needed for raising profits in the future. This value needs to be discounted as per the time frame to find out the annualized rate of return for the shareholder. In Shareholder Wealth Maximization, it places priority before any other objective for the organization. Any action which has positive effective on Shareholder Wealth Maximization needs to be given priority.

In any capitalistic society, the goal of business should be Shareholder Wealth Maximization as mostly the ownership of goods and services is by individuals, since, they own all the means so that they can make money. Shareholder Wealth Maximization at the end leads to rise in value of the shares which at end maximizes wealth of the shareholder (Ahlstrom 2010, pp 11-24). .

Maximizing Shareholder Wealth as the Primary Goal

Any financial decision to become effective needs better understanding of organizational goals. Shareholder Wealth Maximization should guide the decision making of the firm which needs to be represented in the common stock price. Profit maximization shouldn't overshadow Shareholder Wealth Maximization as many a times decisions taken to maximize profits of the owner has a short term view and in the long term erodes the value of shareholder wealth. Warren Buffet, who has been the advocate of Shareholder wealth, says that long term economic goal of any organization should be increasing the average annual gain of the intrinsic business value in their firm for their shareholders. Economic progress isn't shown by size of firm but by per share progress (Smith 2003, pp 52-76).

Shareholder Wealth Maximization goal should be about management of firm seeking to increase the present value of their future of their shareholder but not increasing the profits of promoters. This return to shareholder needs to be given in the form of periodic dividends as well as if any shareholder decided to sell of the stock. As long as the dividend stream or the value stream is flowing, it increases the value of shareholder. Also, the higher the risk for future wealth growth, it reduce the faith of shareholders on the <https://assignbuster.com/problems-with-profit-maximization-strategy-finance-essay/>

company. Stock prices always show what is the timing and risk associated with the future benefits which can be reaped by the shareholders.

Shareholder wealth is defined as per the total number of shares times the value of per share at which it trades in the stock exchange the company is listed (Van Beurden & Gosling 2008, pp 407-424).

The advantages of using Shareholder Wealth Maximization as an objective are:-

This considers the time period as well as the risk in investing in the firm.

Managers must take in account this while making decisions like expenditure so that in contributed to increase shareholder wealth.

Shareholder Wealth Maximization can be tested with every decision which is made by organization so that consistency in decisions can be maintained. If the decision increase shareholder wealth it is a good decision, otherwise it isn't, hence it shouldn't be taken.

Shareholder Wealth Maximization is impersonal by nature. Shareholder is free to take their funds out and sell the shares and invest anywhere. If the shareholders risk preference isn't according to the decisions made by the firm, the shareholder will sell the sticks owned by him and invest in the organization which has best profile as per his investment needs (Bejou 2011, pp 1-6).

For all of these reasons, Shareholder Wealth Maximization should be the primary goal to be achieved by any firm. But, the issues like social responsibilities managerial objectives, agency problems can create

departure from pure Shareholder Wealth Maximization behavior shown by managers as well as promoters and more considerate in profit maximization. Nonetheless, Shareholder Wealth Maximization objective gives a standard on which every managerial decision can be judged and screened on (Ahlstrom 2010, pp 11-24). .

Divergent Objectives

The goal of shareholder wealth maximization is about how financial decisions should be made in an organization. But, not all management decisions need to be made by this. Using the index of managerial performance, we can measure the managerial success in achieving the shareholder wealth maximization objective. They should try and work to maximize Economic Value addition which is the difference between profit after tax and the cost of capital employed to generate that profit. Multiple corporations like Coca Cola, AT & T, and General Electric use this concept of Economic Value added (Husted & de Jesus Salazar 2006, pp 76-91).

It has been seen that all those firms which don't give attention to stockholder interests and are more indulged in promoter profit maximization perform poorly in long term. There is always a divergence in shareholder wealth maximization goal and the other objectives which are undertaken by management. The main reason for this divergence is shareholders are real owner but control is with promoters in all corporations. This separation of ownership and control allows manager to pursue self-promoting goals which are not in line with shareholder wealth maximization. They are consistent to maintain the control of the company. Instead of pursuing the goal of shareholder wealth maximization, managers just work for satisfying or look <https://assignbuster.com/problems-with-profit-maximization-strategy-finance-essay/>

for acceptable levels of shareholder wealth increase, while working for their interest improvement (Shaw 2009, pp 565-576).

The maximization of personal welfare of managers can lead to long run job security of themselves. The focus on long term survival of managers limits the risk taken by firm as unfavorable outcomes can lead to disastrous outcomes for the firm. Similarly, the need for job security is one reason why management doesn't allow any merger offers given by other companies. The "Golden Parachute" approach is usually in the interests of managers more than the shareholders wealth. Now days, multiple companies give top management stock options which ensures their ownership in the company. Pan-American gives retirement option in common stocks which ensures that they think on the options to increase the share price. This helps in alignment of interests of managers with those of shareholders (Bejou 2011, pp 1-6).

Agency Problems

The presence of different objectives of owners and managers is one kind of agency relationship problem. Agency relationships happen when one individual hires other individual so that he can perform duties on behalf of his. They delegate the decision making to the agent. These kinds of agency relationships exist between stockholders and managers and those of stockholders and creditors. When we talk about agency relationship between stockholders and managers, the inefficiency rises as each party works in a way to maximize its interests and utility. The management thinking for looking for long term survival rather than thinking about shareholder wealth maximization. Other example is about using company airplanes, limousines and offices without having any ownership in the firm. This shirking by <https://assignbuster.com/problems-with-profit-maximization-strategy-finance-essay/>

managers is an issue. Enron Corp lost \$1 billion of investments in 2001. In 1991, Enron permitted their CFO to purchase assets and minimize the risk of Enron. The CFO made million personally. This conflict of interests made way for Enron filing for bankruptcy in Chapter 11 (Smith 2003, pp 52-76).

In Enron Case, the agency issue was poorly handled which led to shareholders feel the brunt of this mismatch. Agency costs include

- 1) Expenditures made for minimizing the incentives for management which management took for removing decisions in contrast of shareholder interest, Such as giving management compensation in from of stock option of the firm.
- 2) Expenditure to oversee management action like audits both external and internal.
- 3) Protection of organization from managerial dishonesty.
- 4) Opportunity cost of lost chances due to complex structure of organization (Husted & de Jesus Salazar 2006, pp 76-91).

Managerial motivation act in the stockholder interest when they have stock in form of compensation, the threat of losing their job and threat of being taken over by any other organization. Agency problems and related costs can be decreases if financial markets are efficient enough. Also, it can be done with the use of complex contracts in financial terms. Agency problems lead to costs which reduce the value of firm on market place (Bejou 2011, pp 1-6).

The Other agency conflict is between shareholder and creditors starts from the relation between owners and creditors. Creditors always stake a fixed claim on company's resources in lieu of long term debts, bank loans, commercial agreements and other instruments. The returns given to creditors are fixed while those to shareholders are variable due to stock price. Owners can try to make risky investment decisions, but creditors need to be paid back in full but investments need to be made as early as possible. Creditors to protect their money ask for other protective covers from company line bond indentures, limitation on dividend payments, types of Investments Company can make, poison pills and new debt application. This all can reduce the potential market value of the firm (Ahlstrom 2010, pp 11-24).

Problems with Profit Maximization strategy

If Managers of any firm want to work in the direction of shareholder wealth maximization, they should look beyond their conventional thinking of owner profit maximization. Profit maximization model isn't useful for decision making due to multiple reasons like -

- 1) The standard macroeconomic model for any firm is static. Profit maximization can't compare short term and long term profits. Profit decisions should be reflected on time basis. And should have a long term impact on the firm
- 2) Profit is defined in accounting terms between costs and revenue, but it doesn't define any priority on multiple things like maximization of absolute profit, rate of profit as well as earnings per share.

3) The last problem is profit maximization of owners gives no way for managers to seek the risk assessment option. Two projects giving same profits can have different risk profile (Cosans 2009, pp. 391-399)

Conclusion

The complete concentration on shareholder wealth maximization has been under criticism since the dot com burst. A shareholder value increase talks about benefit of the owners only but doesn't talk about the social issues like employment, environment and ethics. Any management decision can maximize shareholder value but can lower welfare of other stakeholders listed above. A Company while making decisions for maximizing shareholder value can also prove detrimental to interests of its customers as multiple decision regarding product lines can have effect. Also, shareholder wealth maximization strategy needs to have a long term view not a short term one. The intrinsic value of any business is brought up by the combination of financial might, societal contribution, employee satisfaction and shareholder interest's maximization. This is said to be stakeholder value maximization. However, this concept is very hard to implement as every decision can't be useful to all stakeholder. They need to be prioritized and weighted upon before implementing any managerial decision