

Shareholders Wealth Maximization: Objective of Financial Management Revisited.

Zubair Ahmad Khan¹, Irem Hussanie²

^{1,2}Department of Management Studies, University of Kashmir

ABSTRACT

From the various objectives proposed for a business concern, shareholders' wealth maximization is considered the most appropriate and sustainable objective for a business concern. Shareholders wealth maximization criterion proposes that a business concern should only consider the decisions that maximize the market value of the share or the shareholders' wealth. The market value of share is treated as an indicator of efficiency and effectiveness of the firm. Finance theory asserts that shareholders' wealth maximization is the single substitute for shareholders' utility. When the firm maximizes the shareholders' wealth, the individual shareholder can use this wealth to maximize his individual utility. It means that by maximizing shareholders' wealth the firm is consistently operating towards maximizing shareholders' utility. Although this criterion has proved superior to objectives proposed earlier, yet it does not find significant use in the industry primarily due to its complexity in understanding, calculation and application. The article does not recommend any new conceptual model or framework but provides an elementary base for an imminent exhaustive exploration of the said objective in present business context, as the shareholders' wealth maximization is intensely an interdisciplinary and multidisciplinary concept in its philosophical underpinnings.

Key words: Financial Management, NPV, Return. Risk Shareholders, Wealth

INTRODUCTION

The modern finance theory operates on the assumption that the only objective of a business concern should be to maximize the market value of the share or shareholders' wealth. Shareholders' wealth is expressed by the relation; SW (Shareholders' Wealth) = $n \times MV$ (Number of Shares held \times Market Value Per Share). It is clear from the expression that given the number of shares held, the shareholders' wealth can be maximized by maximizing the market value per share. Hence conferring to this objective, every business decision should ultimately lead to maximization of the market value of the share.

According to the shareholders' wealth maximization (SWM) criterion a business concern should undertake only those projects whose Net Present Value (NPV) is positive i.e. present value of cash inflows should be greater than present value of cash outflows. Hence, SWM is often translated as maximizing the Net Present Value (NPV) of a course of action to shareholders. The projected net cash flows; EBDAT (Earnings before depreciation and after tax) are converted to their respective present values by discounting them with an appropriate discount rate (K). As per the contemporary finance theory, the best rate to discount the cash flows of a firm is the Opportunity Cost of Capital (K). The Opportunity Cost of Capital (K) is the rate of return on alternative investments of equivalent risk or the rate of return on the next best alternative investment. The expected cash flows of risky investments are discounted at a higher rate while that of a safer investment are discounted at lower rate. Projects or investments whose NPV is positive are recommended as they increase the market value of the shares, hence increasing the shareholders' wealth, while investments with negative NPV reduces the shareholders' wealth and hence should be rejected. A firm would be indifferent regarding projects with zero NPV as they keep the shareholders' wealth unchanged.

Net Present Value (NPV)

$$NPV = \sum_{t=1}^T \frac{\text{Cash Flow}_t}{(1+i)^t} - \text{Initial Cash Investment}$$

t = Cash Flow Period
i = Interest Rate Assumption

Figure I

Further, in accordance with SWM criterion, in all the financial decisions; investment, financing and dividend, the risk relationship must be optimized (Risk-Return Trade-off) i.e. maximizing return while minimizing risk, as presented in Figure II. For instance new or innovative investments can fetch above average returns for a firm but they also expose the firm to higher risk while safer investments can only fetch average profits for the firm while reducing risk exposure. Hence, a financial manager has to ensure best returns for an investment while minimizing the risk exposure. If a firm employs financial leverage for financing its investments, it will be able to retain its control and minimize its overall cost of capital on account of lower cost of debt and interest tax shield, but it is simultaneously exposed to greater financial risk. Financial risk in this case is created due to the fact that the obligations of debt-holders or creditors are legal. Creditors have priority claims on income and assets of a firm.

If their claims in terms of payment of interest or principal are not met, they may enforce the firm to liquidate its assets. Equity financing on the other hand does not expose the firm to financial risk as shareholders will not liquidate a firm due to their residual claims on income and assets and due to their priority claims on ownership of the business concern. But due to high cost and the tax burden associated with it, equity financing increases the overall cost of capital of the firm. Further it dilutes the ownership of a business concern. Keeping in view the risk and return associated with financing decision, here the manager has to ensure an optimal capital structure i.e. best mix of debt and equity funds which minimizes the overall cost of capital and maximizes the market value of share. Similarly, in dividend decision a firm faces the risk and return trade-off. In dividend decision, the financial manager has to strike a balance between pay-out and retention of dividend and also the issue of bonus shares.

A higher dividend pay-out may convince the shareholders of a concern but due to external financing its cost of capital will increase hence reducing the profitability. As an alternative, if the concern retains the dividend and reinvests it, the cost of capital will significantly reduce while increasing the profitability. But such a decision will increase the risk for the firm so far as the shareholders are concerned. Hence in dividend decision a manager has to ensure optimum pay-out and retention ratio in consideration with the risk and return associated with them.

Finally, in the short term investment or liquidity or working capital management decision also risk return trade-off exists. Here this trade-off is expressed in terms of the relation between liquidity and profitability. If a business concern keeps higher liquidity level i.e. increases the level of cash and cash equivalents, it will be timely able to cover its liabilities thus reducing risk, but due to increased idle funds it will lose profitable opportunities. Now if the liquidity level is decreased, funds will be mobilized from savings to investment which will increase the returns for the concern, but due to decreased level of cash and cash equivalents the firm is exposed to higher degree of risk. Hence, there is wedge between liquidity and profitability in terms of risk and return which must be optimized in terms of an optimum level of cash and cash equivalents.

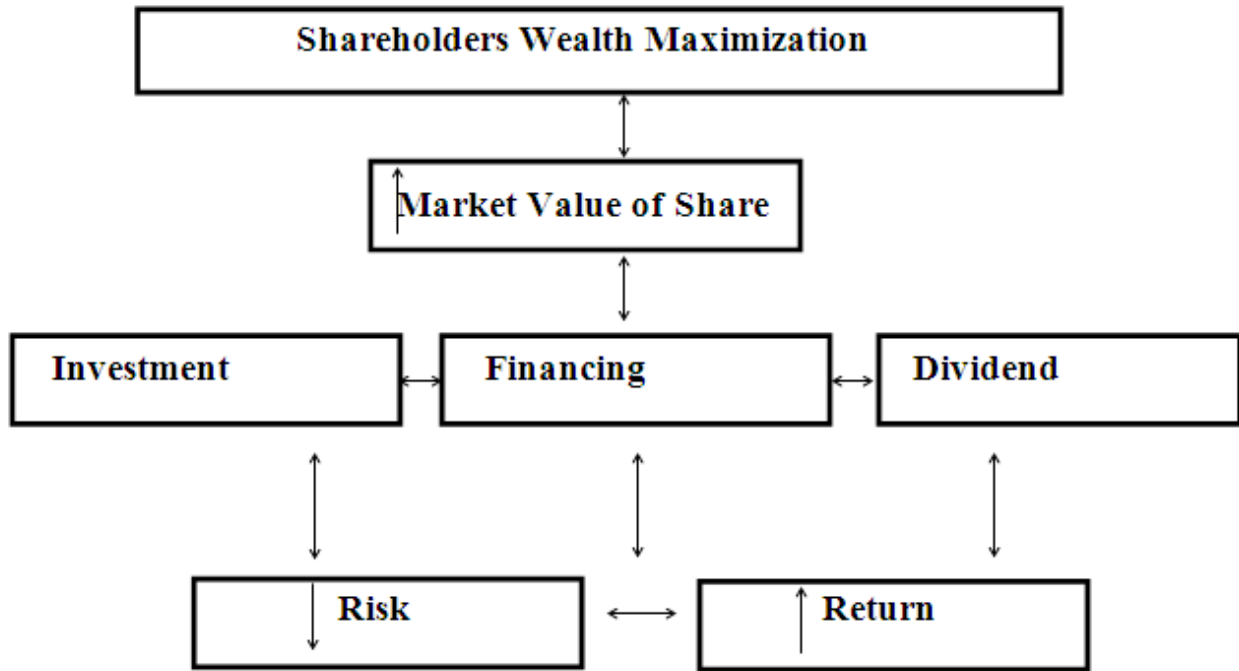


Figure II: Working logic of wealth maximization objective (risk-return trade off)

Thus by optimizing the risk and return relationship in all financial decisions viz. investment (short term and long term), financing and dividend, a firm would be able to maximize the market value of its shares and hence maximizes the shareholders' wealth. This is the operating logic and backbone of Shareholders Wealth Maximization.

Although the efficiency of this criterion remains unchallenged, yet it does not find the application as expected. This is primarily due to the complexity in its understanding and calculations and also carries time and cost constraints. Further due to the availability of convenient alternative approaches like profit maximization, the use and significance of this approach is undermined (Khan, Z.A., 2017).

REFERENCES

- [1] Anthony, R. N. (1960). The trouble with profit maximization. Harvard Business Review, 38(6), 127-134.
- [2] Pandey, I. M. (1995). Essentials of Financial Management, 4th Edition. Vikas publishing house.
- [3] Gupta Shasi, K., & Sharma, R. K. Financial Management Theory and Practice. Kalyani publication,.
- [4] Khan, Z. A. (2017). Profit Maximization as an objective of a firm: A Robust Perspective.
- [5] NS Tung, V Kamboj, A Bhardwaj, "Unit commitment dynamics-an introduction", International Journal of Computer Science & Information Technology Research Excellence, Volume 2, Issue 1, Pages 70-74, 2012.
- [6] International Journal of Research in Finance and Marketing,7(6), 217-219.
- [7] Van Horne, J. C., & Wachowicz, J. M. (2008). Fundamentals of financial management. Pearson Education.