

FINANCIAL MANAGEMENT

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GOALS OF FINANCIAL MANAGEMENT

Profit Maximization as Objective of Financial Management

- (i) Main purpose of most businesses is to earn profits.
- (ii) Profit can be a suitable criterion for measuring success of business operations.
- (iii) Profit maximization ensures efficient utilization of scarce financial resources as the resources are allocated to uses which generate maximum profits.
- (iv) Profit maximization may lead to maximization of economic welfare of society.

Since each individual component of society would seek maximum profitability, the economic welfare of society as a whole would be maximized

CRITICISM

- (i) It is a vague and ambiguous objective. The term profit is not specifically defined. It can mean Profit after tax or profit before tax, total profit or incremental profits.
- (ii) It does not consider the time value of money: Timing of receipt of benefits (cash inflows) is not considered. It does not make any difference between cash inflows occurring at different points of time.
- (iii) It ignores risk: Quality of benefits is also ignored. Profit maximization does not consider risk of not receiving or receiving less than expected cash inflows.
- (iv) The objective of a business enterprise is not just to maximize profit but also to create value for its owners.
- (v) Based on Accounting Profit: Accounting profits can be easily affected by management through altering of accounting policies underlying the calculation of accounting profits.

SHAREHOLDER'S WEALTH MAXIMIZATION (SWM) AS OBJECTIVE OF FINANCIAL MANAGEMENT

- In the modern phase, the objective of financial management is considered to be Shareholder's Wealth Maximization. Since it is based on the concept of cash flows and considers timing of benefits, it overcomes the limitations of Profit Maximization objective and provides a realistic objective
- Shareholders' wealth includes market value of company's shares, reserves and surplus, accumulated profits. However, the main component is market value of shares. $\text{Market Value of Shares or Market Capitalization} = \text{Market price per Share} \times \text{No. of Shares}$. Therefore, the finance manager should take all financial decisions in such a way that market value of firm's shares is maximized. Now since the no. of shares remain fixed over a given period of time, the focus of finance manager should be on maximization of market price per share so that shareholder's wealth is maximized. Finance manager may achieve higher share price quickly by selecting high risk-high return projects. But this may backfire which could result in a significant fall in share prices. If shareholders are not satisfied with the functioning of management or progress of the organization, they can communicate their displeasure by selling company's share which would end in a fall in share prices.

MAXIMIZATION OF ECONOMIC VALUE ADDED (EVA)

- The EVA can be obtained by deducting cost of funds used to finance an investment project from after-tax operating profits generated by the project.
- $EVA = \text{Net Operating Profit after Tax} - \{\text{Firm's Weighted Average Cost of Capital (\%)} * \text{Total Capital Invested}\}.$

MAXIMIZATION OF EARNING PER SHARE (EPS)

- EPS is obtained by deducting Preference share dividend from Net Income after tax and dividing by average outstanding equity shares. It gives earning per equity share.
- Earning Per Share (EPS) = $\frac{\text{Net Income after Tax} - \text{Dividend On Preference Shares}}{\text{Average Outstanding Equity Shares}}$