RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA III SEM.

SUBJECT: FINANCIAL MANAGEMENT

SUBJECT CODE: BBA 303

LECTURE: 4

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LECTURE-4

Wealth Maximization:

Wealth maximization is the concept of increasing the value of a business in order to increase the value of the shares held by its stockholders. The concept requires a company's management team to continually search for the highest possible returns on funds invested in the business, while mitigating any associated risk of loss. This calls for a detailed analysis of the cash flows associated with each prospective investment, as well as constant attention to the strategic direction of the organization.

The most direct evidence of wealth maximization is changes in the price of a company's shares. For example, if a company spends funds to develop valuable new intellectual property, the investment community is likely to recognize the future positive cash flows associated with this new property by bidding up the price of the company's shares. Similar reactions may occur if a business reports continuing increases in cash flow or profits.

The concept of wealth maximization has been criticized, since it tends to drive a company to take actions that are not always in the best interests of its stakeholders, such as suppliers, employees, and local communities. For example:

- A company may minimize its investment in safety equipment in order to save cash, thereby putting workers at risk.
- A company may continually pit suppliers against each other in the unmitigated pursuit of the lowest possible parts prices, resulting in some suppliers going out of business.
- A company may only invest minimal amounts in pollution controls, resulting in environmental damage to the surrounding area.

Because of these types of issues, senior management may find it necessary to back away from the sole pursuit of wealth maximization, and instead pay attention to other issues, as well. The result is likely to be a modest reduction in shareholder wealth.

Given the issues noted here, wealth maximization should be considered just one of the goals that a company must attend to, rather than its only goal.

Financial theory asserts that the wealth maximization is the single substitute for a stake holder's utility. When the firm maximizes the shareholder's wealth, the individual stakeholders can use this wealth to maximize his individual utility. It means that by maximizing stakeholder's wealth the firm is operating consistently toward maximizing stakeholder's utility. A stake solder's wealth in the firm is the product of the numbers of the shares owned, multiplied within the current stock price per share.

Stockholder's current wealth in the firm = (No. Of shares owned) * (Current stock price per share)

Higher the stock price per share, the greater will be the shareholder's wealth. Thus a firm should aim at maximizing its current stock price, which helps in increasing the value of shares in the market.