Objectives of Financial Management

Financial management is concerned with procurement and use of funds. Its main aim is to use business funds in such a way that the firm's value / earnings are maximized. Financial management provides a frame work for selecting a proper course of action and deciding a viable commercial strategy. The main objective of a business is to maximize the owner's economic welfare. This objective can be achieved by;

1. Profit Maximization, and
2. Wealth Maximization.

1. Profit Maximisation. Profit earning is the main aim of every economic activity. 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. Profit is a measure of efficiency of a business enterprise. Profits also serve 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 the main objective of business. The following arguments are advanced in favour of profit maximization as the objective of business:

1. When profit-earning is the aim of business then profit maximization should be the obvious objective.
2. Profitability is a barometer for measuring efficiency and economic prosperity of a business enterprise
3. 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.
4. 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.
5. Profitability is essential for fulfilling social goals also. A firm by pursuing the objective of profit maximization also maximizes socio-economic welfare.

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;

1. 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.
2. 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.
3. It does not take into consideration the risk of the prospective earnings stream. Some projects are more risky than other.
4. The effect of dividend policy on the market price of shares is also not considered in the objective of profit maximization.

2. Wealth Maximization. Wealth maximization is the appropriate objective of an enterprise. When the firm maximizes the stockholder’s wealth, the individual stockholder can use this wealth to maximize his individual utility. It means that by maximizing stockholder’s wealth the firm is operating consistently towards maximizing stockholder’s utility.

A stockholder’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 or report card 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.

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

Criticism of Wealth Maximization. The wealth maximization objective has also been criticized by certain financial theorists mainly on following accounts;

1. It is a prescriptive idea. The objective is not descriptive of what the firms actually do.

2. The objective of wealth maximization is not necessarily socially desirable.
3. There is some controversy as to whether the objective is to maximize the stockholders wealth or the wealth of the firm which includes other financial claimholders such as debenture holders, preferred stockholders, etc.,
4. The objective of 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 wealth maximization is the most appropriate objective of a firm and the side costs in the form of conflicts between the stockholders and debenture holders, firm and society and stock holders and managers can be minimized.

What is Financial Leverage?

The use of fixed-charges sources of funds, such as debt and preference capital along with owner's equity in the capital structure described as financial leverage gearing or trading on equity. The use of the term trading on equity is derived from the fact that is the owner's equity that is used to raise debt; that is, the equity that is traded upon.

Financial leverage is defined as the ability of a firm to use fixed financial charges to magnify the effect of change in E.B.I.T on the firm's earning per share. The financial leverage occurs when a firm's Capital Structure contain obligation of fixed financial charges. For instance, interest on debentures, dividend on preference share etc., along with owner's equity to enhance earning of equity shareholder's. The fixed financial charges do not vary with the operating profit. They are fixed and are to be paid irrespective of level of operating profit. The ordinary shareholders of firm are entitled to residual income i.e. earning after fixed financial charges.

The financial leverage employed by a company is intended to earn more on the fixed charges funds than their costs. The surplus (or deficit) will increase (or decrease) the return on the owner's equity. The rate of return on the owner's equity is levered above or below the rate of return on the owner's equity.

Favourable and Unfavourable Financial Leverage

Financial leverage may be favourable or unfavourable depending upon whether the earning made by the use of fixed interest or dividend bearing securities exceeds the explicit fixed cost, the firm has to pay for the employment of such funds or not. The leverage will be considered to be favourable so long the firm earns more on assets purchased with the funds than the fixed cost of their use. Unfavourable leverage occurs when the firm does not earn as the funds cost.

Significance of Financial Leverage

Financial leverage helps in deciding the appropriate Capital Structure. One of the objectives of planning an appropriate Capital Structure is to maximize the return on equity shareholders funds or maximize the earning per share.

Financial leverage is **double-edged sword.** On one hand, it increases the earning per share and on the other hand it increases the financial risks. High financial leverage means high fixed financial cost and high financial risk i.e., as the debt content in Capital Structure increases, the financial leverage increases and at the same time the financial risk also increases i.e., risk of insolvency increases. The finance manager is required to trade-off between risk and return for determining the appropriate amount of debt.

Importance of Capital Structure Planning

For the real growth of the company the financial manager of the company should plan an optimum capital for the company. The optimum capital structure is one that maximize the market value of the firm. In practice the determination of the optimum capital structure is a formidable task and the manager has to perform this task properly, so that the ultimate objective of the firm can be achieved.

There are significant variations among industries and companies within an industry in terms of capital structure. Since a number of factors influence the capital structure decision of a company, the judgment of the person making the capital structure decisions play a crucial part. A totally theoretical model can't adequately handle all those factors, which affects the capital structure decision in practice. These factors are highly psychological, complex and qualitative and do not always follow accepted theory, since capital markets are not perfect and decision has to be taken under imperfect knowledge and risk.

An appropriate capital structure or target capital structure can be developed only when all those factors, which are relevant to the company's capital structure decision, are properly analyzed and balanced. The capital structure should be planed generally keeping in view the interest of the equity shareholders and financial requirements of the company. The equity shareholders being the owner of the company and the providers of risk capital (equity), would be concerned about the ways of financing a company's operations. However, the interest of other groups, such as employee, customers, creditors, society and government, should be given reasonable consideration when the company lays down its objective in terms of the shareholders wealth maximization, it is generally compatible with the interest of other groups. Thus, while developing an appropriate capital structure for a company the finance manager should inter alia aim at maximizing the long-term market price per share. Theoretically, there may be precise point or range within which the market value per shares is maximum. In practice, for most companies within an industry there may be a range within which there would not be great differences in the market value per share. One way to get an idea of this range is to observe the capital structure patterns of companies vis-a-vis their market prices of share. The management of companies may fix its capital structure near the top of this range in order to make maximum use of favourable leverage, subject to other requirements such as flexibility, solvency, control and norms set by the financial institutions- The Security Exchange Board of India (SEBI) and Stock Exchanges.

Guidelines for Capital Structure Planning

The following are the guidelines of capital structure planning:

1) **Avail or Tax advantage of Debt**

Interest on debt finance is a tax-deductible expense. Hence, finance scholars and practitioners agree that debt financing gives rise to tax shelter which enhances the value of the firm. What is the impact of this tax shelter on the value of the firm? In this 1963 paper Modigilani and Miller argued that the present value of the interest tax shield is-

$t_c D$

where, t_c = corporate tax rate on a unit of marginal earnings and D = Debt financing.

2) **Preserve Flexibility**

The tax advantage of debt should not persuade one to believe that a company should exploit its debt capacity fully. By doing so, it loses flexibility. And loss of flexibility can erode shareholder value. Flexibility implies that the firm maintains reserve borrowing power to enable it to raise debt capital to respond to unforeseen changes in government policies, recessionary conditions in the market place, disruption in supplies, decline in production caused by power shortage or labour market, intensification in competition, and, perhaps most importantly, emergence of profitable investment opportunities. Flexibility is a powerful defence against financial distress and its consequences which may include bankruptcy.

3) **Ensure that the Total Risk Exposure is Reasonable**

While examining risk from the point of view of the investor, a distinction is made between systematic risk (also referred to as the market risk or non-diversifiable risk) and unsystematic risk (also referred to as the non-market risk or diversifiable risk).

Business Risk refers to the variability of earnings before interest and taxes. It is influenced by the following factors:

- **Demand Variability-** Other things being equal, the higher the variability of demand for the products manufactured by the firm, the higher is its business risk.
- **Price Variability-** A firm which is exposed to a higher degree of volatility in the prices of its products is, in general, characterized by a higher degree of business risk in comparison with similar firms which are exposed to a lesser degree of volatility in the prices of their products.

- **Variability in Input Prices-** When input prices are highly variable, business risk tends to be high.

4) **Subordinate Financial Policy to Corporate Strategy**

Financial Policy and Corporate Strategy are often not integrated well. This may be because financial policy originates in the capital market and corporate strategy in the product market.

5) **Mitigate Potential agency Costs**

Due to separation of ownership and control in modern corporations, agency problems arise. Shareholders scattered and dispersed as they are not able to organize themselves effectively. Since agency costs are borne by shareholders and the management, the financial strategy of a firm should seek to minimize these costs. One way to minimize agency costs is to employ an external agent who specializes in low cost monitoring. Such an agent may be a lending organization like a commercial bank (or a term-lending institution).