

ESPOUSING CORPORATE GOVERNANCE



T H R O U G H

Shareholders Wealth
Maximization Trajectory



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Abstract

Wealth maximization is a new approach to financial management. It is a superior goal compared to profit maximization as it takes into account a broader area. Wealth or Value is defined as the market price of capital invested by shareholders. It is to be noted a wealth of a shareholder maximizes when the net worth of a company maximizes. To be even more thorough, a shareholder owns share in the company/business and his wealth moves north if the share price in the market enhances which in turn is a function of net worth. Wealth maximization is also termed as net worth maximization.



The significance of the study lies in the fact that equity shareholders are real owners of a company form of business organizations. They all invest their money in equity shares of a company with basic objective of attaining good capital appreciation and regular and stable return (i.e. dividends). Banking companies are no exception, since banks have witnessed a rapid metamorphosis and so it generates paramount academic and research interests to explore the scenario of maximization of shareholders wealth in listed public limited Indian banking companies. Enhancing shareholders' value and protecting the interests of other stakeholders by improving the corporate performance and accountability is one of the major objectives of corporate governance. The factors that are mainly focused in this research paper in order to judge maximization of shareholders wealth are- Economic Value Added and Market Value Added. However, in this research paper, only Market Value Added technique of measuring shareholder wealth maximization have been applied to judge the selected public and private sector banks performance with respect to shareholders wealth maximization. But in the theoretical portion of the paper economic value added have been also covered.

Keywords: Wealth Maximization in Indian Banking Sector; Market Value Added; Impact on Shareholders Morale.

JEL Classification: G3 (Corporate Finance and Governance)

Full-length paper

Introduction Wealth maximization is the concept of enhancing the value of a business with the objective of pushing up the value of the shares held by stockholders.

The Indian banking system which comprises of 26 public sector banks , 20 private sector banks, 43 foreign banks, 56 regional rural banks, 1,589 urban cooperative banks, in addition to cooperative credit institutions. With its soaring operations the Indian banks are increasingly espousing integrated approach to risk management. Banks have already embraced the international banking supervision accord of Basel II. According to RBI, majority of the banks already meet capital requirements of Basel III, which has a deadline of March 31st, 2019. Majority of the banks have put in place the framework for asset-liability match, credits and derivatives risk management. Further, increasing incomes are expected to increase the requirement for banking services in rural areas and therefore drive the growth of the sector, programs like MNREGA have assisted in enhancing rural income aided by the recent Jan DhanYojana. The Reserve Bank of India (RBI) has relaxed its branch licensing policy, thereby allowing banks (which meet certain financial parameters) to set-up new branches in tier-2 to tier-6 centres, without prior approval from RBI. It has emphasised the need to focus on spreading the reach of banking services to the un-banked population of India. Now with the growing prominence of banking sector, it generates substantial academic and research interests to delve into the scenario of shareholders wealth maximization of Indian banks, since it is the shareholders who are absorbing the maximum risks, thereby, helping the Boards of various banks to ruminate over organic and inorganic growth, and in taking critical decisions.

The concept of wealth maximization calls for a company's management team to continually hunt for the highest possible returns on funds invested

Wealth maximization is the concept of enhancing the value of a business with the objective of pushing up the value of the shares held by stockholders.



in the business, while alleviating any associated risk of loss. This calls for an in-depth analysis of the cash flows associated with each prospective investment, as well as constant attention to the strategic direction of the organization. The wealth maximization objective is almost universally accepted goal of a firm. According to this objective, the managers should take decisions that maximize shareholders wealth. To put differently, it is to make shareholders as rich as possible. It is interesting to observe that financial management has traversed a long journey by changing its focal point from conventional to modern approach. The modern theory concentrates on wealth maximization rather than profit maximization. Wealth maximization concept provides a longer term sphere for assessment, making path for sustainable performance by corporate houses. In today's eon, choosing a corporate objective is highly essential and exert a robust impact on the success or failure of the company in controlling the market. To gain it, shareholder value maximization and stakeholders' interest satisfaction play a crucial role in creating profit for the company.

Now a million dollar question emerges whether to maximize shareholders wealth or satisfy stakeholders' interest? No doubt, stakeholders are also key elements of a corporate, but shareholders wealth maximization is considered to be supreme as they own the company, and in a society which is heading towards capitalism, company form of organization have captured the centre stage. Imagining formation of company, its growth and expansion without the presence and active participation of shareholders is like living in the 'Wonderland of Alice'(Alice in Wonderland by Lewis Carroll).

Shareholder wealth maximization focuses on the motives and behaviours of financial stakeholders. The thesis of separation of ownership and control (Berleand Means 1932) posits that principals (or shareowners) employ agents (or management) who must have some reasonable discretion (e.g, the business judgment rule). At law, officers and directors have a fiduciary duty to safeguard the financial interests of the shareholders (or shareowners).

Shareholder wealth can be defined, at any time, as the market capitalization of the public corporation. This market cap is the number of equity shares outstanding multiplied by the share price at the time of calculation. Market cap is an estimate, by capital markets, of the net worth of the firm. The market cap reflects the firm's tangible assets plus the future expected residual revenues, which may be distributed as dividends or kept as retained earnings. The estimate thus includes the future expected dividend stream. Higher earnings per share (EPS) of common stock (i.e., equity) will tend, ceteris paribus, to increase the market price of each share (and thus the market value of the firm) and to permit in principle either additional investments in profitable projects or higher dividends.

A problem inherent in the market cap definition is that it involves an artificial dimension of subjective valuation by buyers and sellers. There can be artificial bubbles, particularly for real estate and commodities. In a bubble, the price-to-

earnings ratio rises, often rapidly.

The market value added (MVA) of a firm is the difference between the value of equity and net debt and the book value of capital invested. If net debt is equal to book value, then the difference between market capitalization and book value of the shareholders' equity is the market value added. The MVA concept is a way of measuring gain over book value.

Literature Review

Stern (1990) observed that EVA as a performance measure captures the true economic profit of an organization. EVA-based financial management and incentive compensation scheme provides manager better quality information and superior motivation to make decisions that will generate the maximum shareholders' wealth in an organization. EVA is a performance measure which is most closely related to the creation of shareholders' wealth over a period of time.

Hayek (1960) and Friedman (1970) “Says that a firm should be operated in a manner that maximizes its economic profits. In the financial scenario, although the investors always wanted their share value to appreciate but their primary focus was on profits distributed by way of dividends”.

Rappaport (1986) “The business strategies should be judged by economic returns they generate for their shareholders which are measured and increase the share price”.

Kirloy (1993) “Shareholder wealth can only be created if the performance of the management is more than the expectations”.

Milunovich and Tsuei (1996) reviewed the correlations between MVA and several conventional performance measures in the US computer technology industry for the period from 1990 to 1995. The study indicated EVA to have strong correlation with MVA than the other measures of financial performance.

KPMG-BS Study (1998) assessed top companies on EVA, sales, PAT (Profit after Tax), and MVA criteria. The survey has used the BSE 1000 list of companies using a composite index comprising sales, profitability and compounded annual growth rate of those companies covering the period 1996-97. Sixty companies have been found able to create positive shareholder value

Aswath (2001) “Discussed the reasons why the shareholder wealth maximization objective should be the main objective of the firm”.

K.Sunitha (2011) “Banks which eroded shareholders value should invest in growth, keep the cost of capital down, and squeeze optimal returns from its investment to add shareholder value”.

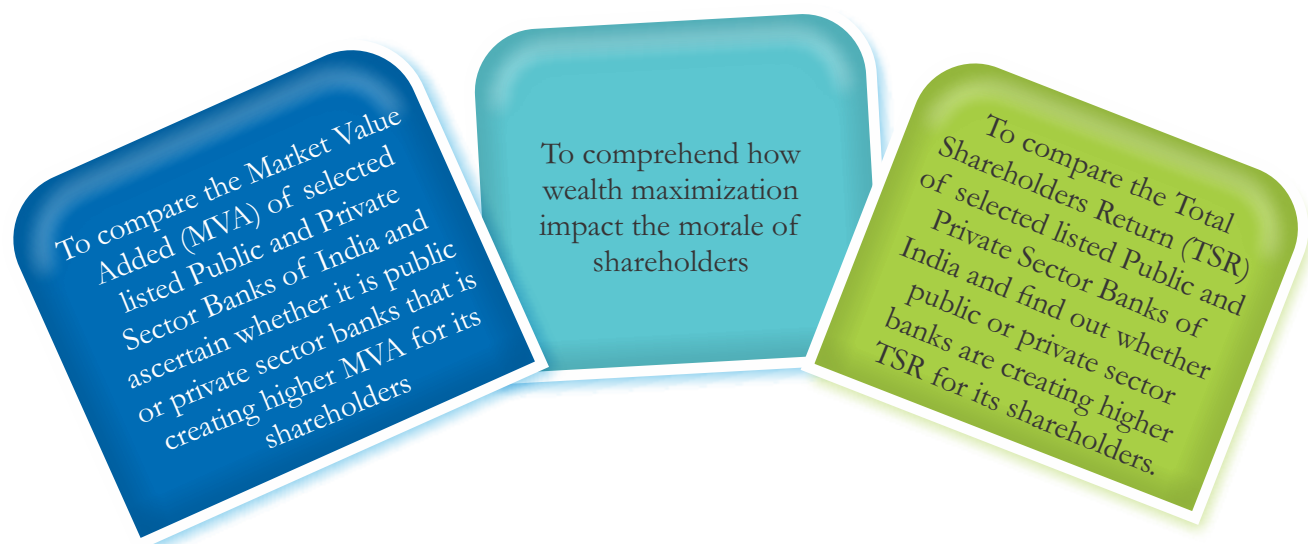
Ashok Thampy (2000) applied the concept of economic value added to the banking and Development Financial Institutions. The results of the study revealed that most banks in the public and private sector, as well as the development financial institutions in India are not earning positive EVA.

Madhu Malik (2004) observed the relationship

between shareholder wealth and certain financial variables such as EPS, RNOW and ROCE. By using correlation analysis, it was found that there was positive and high correlation between EVA and RONW, ROCE. There was a positive but low correlation between EVA and EPS. By using coefficient of determination (r^2), EVA was compared with traditional performance measures and it was observed that not a single traditional performance measure explains to the fullest extent variation in shareholder wealth.

Singh (2005) examined an appropriate way of evaluating bank's performance and also found out which Indian banks have been able to create (or destroy) shareholders' wealth since 1998- 1999 to 2002-2003. This study is based on 28 Indian private and public sector banks that are listed on the Bombay Stock Exchange (BSE). The study suggested that the relationship between EVA and MVA is statistically significant. The study showed impressive performance in terms of EVA by banks such as State Bank of Bikaner and Jaipur, Jammu and Kashmir Bank, Global Trust Bank and IndusInd Bank.

Objective of the study



Research Methodology

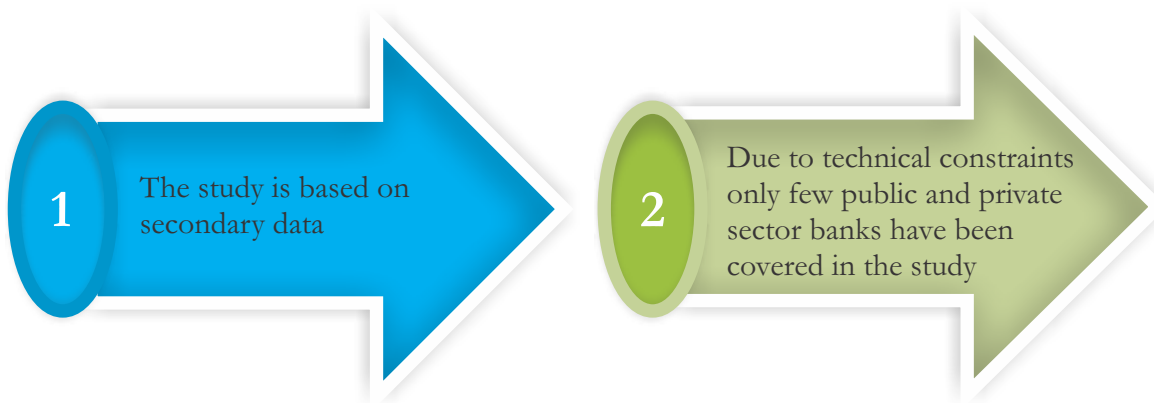
The Market Value Added (MVA) will assist in ascertaining the extent of corporate governance espoused by the selected Public and Private sector banks, i.e. A Ltd., B Ltd., C Ltd., and D Ltd. In order to maintain anonymity of the banks, public sector banks have been named as A Ltd. and B Ltd. and private sector banks have been named as C Ltd. and D Ltd.

Total Shareholders Return Approach

Since Total Shareholders Return (TSR) signifies the change in capital value of a listed / quoted company over a period, i.e. one year or more than that. This financial tool will assist in determining whether the selected public and private sector banks, i.e. A Ltd., B Ltd., C Ltd. and D Ltd. are generating positive or negative shareholders return for the periods considered, i.e. 2012-16

Note: *The financial figures used for the analysis have been referred from the financial statements of these banks. Further, the banks considered for study are leading banks of India.*

Limitations of the study



MVA Approach- Gauging Corporate Governance towards Equity Shareholders

Four banks have been selected at random to judge the magnitude of corporate governance embraced by these four banks towards their shareholders as far as maximization of wealth is concerned. This section also makes an attempt to explore whether public or private sector banks are playing a pivotal role in maximization of shareholders wealth. The banks considered for the study are- A Ltd., B Ltd., C Ltd. and D Ltd.

Market Value Added of A Ltd., B Ltd., C Ltd. and D Ltd. A Ltd.

| Years (A) | Outstanding Equity Shares in Millions (B) | Market price of the shares on 31st March or date nearer to 31st March (C) | Market Capitalization (in INR Million) (D) | Total Common Shareholders' Equity (in INR Million) (E) | Market Value Added (in INR Million) (D – E) |
|-----------|---|---|--|--|---|
| 2012 | 671.04 | 206.14 | 138328.19 | 606,547 | -468218.81 |
| 2013 | 684.03 | 207.28 | 141785.74 | 699,842 | -558056.26 |
| 2014 | 746.57 | 190.20 | 141997.61 | 919,850 | -777852.39 |
| 2015 | 7465.70 | 267.05 | 1993715.19 | 1,007,818 | 985897.19 |
| 2016 | 7763.60 | 194.25 | 1508079.30 | 1,071,014 | 437065.30 |
| | | | | | -381165 |

B Ltd.

| Years (A) | Outstanding Equity Shares in Millions (B) | Market price of the shares on 31st March or date nearer to 31st March (C) | Market Capitalization (in INR Million) (D) | Total Common Shareholders' Equity (in INR Million) (E) | Market Value Added (in INR Million) (D – E) |
|-----------|---|---|--|--|---|
| 2012 | 339.18 | 185.21 | 62819.53 | 185,469 | -122649.5 |
| 2013 | 353.47 | 143.50 | 50722.95 | 239,150 | -188427.05 |
| 2014 | 362.07 | 148.82 | 53883.26 | 262,608 | -208724.74 |
| 2015 | 1854.56 | 148.55 | 275494.89 | 293,369 | -17874.11 |
| 2016 | 1963.60 | 85.55 | 167985.98 | 299,237 | -131251.02 |
| | | | | | -668926.42 |

C Ltd.

| Years (A) | Outstanding Equity Shares in Millions (B) | Market price of the shares on 31st March or date nearer to 31st March (C) | Market Capitalization (in INR Million) (D) | Total Common Shareholders' Equity (in INR Million) (E) | Market Value Added (in INR Million) (D – E) |
|-----------|---|---|--|--|---|
| 2012 | 782.23 | 520.05 | 406798.71 | 235,059 | 171739.71 |
| 2013 | 793.14 | 624.10 | 494998.67 | 281,284 | 213714.67 |
| 2014 | 799.68 | 744.95 | 595721.62 | 334,542 | 261179.62 |
| 2015 | 835.50 | 1022.85 | 854591.18 | 495,654 | 358937.18 |
| 2016 | 842.73 | 1071.20 | 902740.80 | 573,208 | 329532.80 |
| | | | | | 1335103.98 |

D Ltd.

| Years (A) | Outstanding Equity Shares in Millions (B) | Market price of the shares on 31st March or date nearer to 31st March (C) | Market Capitalization (in INR Million) (D) | Total Common Shareholders' Equity (in INR Million) (E) | Market Value Added (in INR Million) (D – E) |
|-----------|---|---|--|--|---|
| 2012 | 1152.59 | 177.45 | 204527.09 | 449,655 | -245127.91 |
| 2013 | 1153.69 | 209.07 | 241201.97 | 489,471 | -248269.03 |
| 2014 | 1155.10 | 251.75 | 290796.43 | 520,898 | -230101.57 |
| 2015 | 5774.16 | 314.40 | 1815395.90 | 565,145 | 1250250.9 |
| 2016 | 5797.24 | 236.55 | 1371337.12 | 571,893 | 799444.12 |
| | | | | | 1326196.51 |

Total Shareholders Return (TSR) of A Ltd., B Ltd., C Ltd. and D Ltd.

Share Price at End of Period – Share Price at Beginning of Period + Dividends

x 100

Share Price at Beginning of Period

A Ltd.

| Years | Share Price at End of Period | Share Price at Beginning of Period | Dividends | TSR |
|-------|------------------------------|------------------------------------|-----------|---------|
| 2012 | 209.50 | 271.95 | 35 | -10.09% |
| 2013 | 207.28 | 209.50 | 41.50 | 18.74% |
| 2014 | 191.83 | 209.06 | 30.00 | 6.11% |
| 2015 | 267.00 | 189.46 | 3.50 | 42.77% |
| 2016 | 194.30 | 273.45 | 2.60 | -27.99% |

B Ltd.

| Years | Share Price at End of Period | Share Price at Beginning of Period | Dividends | TSR |
|-------|------------------------------|------------------------------------|-----------|---------|
| 2012 | 185.21 | 235.89 | 22.00 | -12.16% |
| 2013 | 143.50 | 185.21 | 27.00 | -7.94% |
| 2014 | 148.82 | 145.01 | 10.00 | 9.52% |
| 2015 | 144.40 | 146.92 | 3.30 | 0.53% |
| 2016 | 84.70 | 151.70 | 0.00 | -44.17% |

C Ltd.

| Years | Share Price at End of Period | Share Price at Beginning of Period | Dividends | TSR |
|-------|------------------------------|------------------------------------|-----------|--------|
| 2012 | 520.00 | 466.73 | 4.30 | 12.33% |
| 2013 | 624.10 | 520.05 | 5.50 | 21.06% |
| 2014 | 748.85 | 623.90 | 6.85 | 21.1% |
| 2015 | 1022.85 | 738.10 | 8.00 | 39.66% |
| 2016 | 1071.20 | 1033.85 | 9.50 | 4.51% |

D Ltd.

| Years | Share Price at End of Period | Share Price at Beginning of Period | Dividends | TSR |
|-------|------------------------------|------------------------------------|-----------|---------|
| 2012 | 177.45 | 220.54 | 16.50 | -12.05% |
| 2013 | 209.07 | 177.45 | 20.00 | 29.08% |
| 2014 | 249.09 | 210.36 | 23.00 | 29.34% |
| 2015 | 315.30 | 244.76 | 5.00 | 30.86% |
| 2016 | 236.55 | 322.90 | 5.00 | -25.19% |

Impact of Wealth Maximization on Shareholders Morale

It is a well accepted fact that in corporate form of business, the ownership lies with the shareholders and so maximization of their wealth is an apposite objective. Several scholars and managers have supported the idea that the basic purpose of the firm is to make money for its managers. Moreover, the shareholder wealth maximization objective is justified on the grounds that it maximizes social welfare. At a global level, the dominant normative mandate for managers of US corporations is the maximization of the wealth of the company's shareholders, basically through the maximization of the profits. Indeed, a number of studies show that directors identify their mission as enhancing shareholders wealth (Alexander, 1999; Korn / Ferry International, 2000) and that this prioritization has intensified over time (Gordon, 2007; Pye, 2002).

The concepts of wealth maximization do

exert a positive impact on the shareholders, as it is based on cash flows and not on profits. Unlike the profits, the cash flows are exact and definite and thus avert any ambiguity associated with accounting profits. On the other hand, profit maximization presents a shorter term view as compared to wealth maximization. Short-term profit maximization can be attained by managers at the cost of long-term sustainability of the business. Wealth maximization takes into account the time value of money. It is important as we are all conversant with the fact that a rupee today and a rupee one year hence do not have the same value. In wealth maximization, the future cash flows are discounted at an appropriate discounted rate to represent their present value. Very importantly, wealth maximization criterion considers the risk and uncertainty factor while considering the discounting rate. The discounting rate reflects both time and risk. Higher the uncertainty, the discounting rate is higher and vice-versa. It needs to be understood that the ability of the firm in producing maximum output with the limited input, or it uses minimum input for manufacturing the stated output.

It has been conventionally recommended that the evident motive of any business organization is to earn profit, as it is essential for the success, survival and growth of the company. Profit is a long-term objective, but it has a short-term perspective i.e. one financial year. On the contrary, wealth maximization is the capability of the firm to enhance the market value of its common stock over time. It is the versatile goal of the company and highly recommended parameter for assessing the performance of a business organization.

Every corporate house commences and continues its operations with an objective and selection of right objective have a strong bearing on the success or failure of a corporation in controlling the market. To gain it, shareholder value maximization and stakeholders' interest satisfaction play a pivotal role in creating profit for the company. As mentioned above, shareholders being the owners of the company, have potential profit if the company performs well or potential loss if the company performance is abysmal. Therefore, wealth maximization enhances the morale of the shareholders. Maximizing shareholder wealth implies maximizing the flow of dividends to shareholders through time (Glen Arnod, 2008). So enhancement in dividends which is a source of regular income for the shareholders goes a long way in strengthening their morale. Thus, to sum up, wealth maximization possess the following benefits which in turn improves shareholders morale-

a) Economists like Bartley Madden and James Owens consider the maximization of shareholder wealth to be the natural outcome of profitable business practices. These, in turn, are also the same, or similar, to capital expansion. These two writers differ on this as the goal of all business, but the general idea is that such expansion is what makes shareholders happy. This leads to loyal shareholders, committed board members and the continual increase in share value. The media attention that such performance can generate can assist the public reputation of any firm.

b) Other than maintaining happy shareholders and gaining a powerful reputation, maximizing shareholder value has many advantages. It is almost too palpable that constant profits, reinvestment and expansion makes everyone happy. Managers see salaries and reputations increase, salesmen see high commissions, governments see more tax funds and more people are being hired to staff the expanding firm. While the disadvantages of this policy are not negligible, the vivid impression these advantages make on investors cannot be ignored.

c) Madden holds that maximizing shareholder wealth is not just the obvious purpose of the firm, but is also a requirement for the maximizing of social utility. If a firm is continually growing, investing and expanding, everyone benefits. Other corporate strategies, such as increasing market share, can lead to declining profits, which, in turn, can lead to higher interest rates on loans for any future investment. If a corporation takes profit and expansion as its sole purpose and goal, then all problems of the firm are smoothed out. In other words, questions of the long or short term, market share or even social responsibility are eliminated as the firm continues to expand. It is not about corporate "profits" in isolation, but rather the "wealth" of shareholders, which includes long-term planning, capital expansion and continual investment in equipment, land and buildings.

Data Analysis & Findings

By applying Market Value Added approach it can be stated that C Ltd. is the star performer as it has positive market value added for all the five years, whereas B Ltd. performance is not impressive since in all the five years the MVA is negative. As far as A Ltd. and D Ltd. Banks are concerned their performance is somewhat better as they are showing signs of improvement. Thus, by applying MVA approach it can be observed that one public (A Ltd.) and one private sector (D Ltd.) bank is performing well.

By using Total Shareholders Return method, it can be observed that C Ltd. is the star performer among the banks considered for the study, as it has fetched its shareholders with positive TSR for the periods considered for the study (2012-2016). A Ltd. and D Ltd. performance is somewhat impressive as they have fetched positive TSR for the years 2013, 2014 and 2015, whereas negative TSR for the years 2012 and 2016. TSR of B Ltd. is abysmal as its TSR is mostly into negative territory, i.e. for 2012 (-) 12.16%; 2013 (-) 7.94% and for 2016 it is highly negative i.e. (-) 44.17%. Thus, it can be stated that TSR of private sector banks are far better, especially looking into C Ltd. in comparison to public sector banks. However, by employing proper business strategies and through pragmatic and planned approach, banks which are having negative TSR can improve their performance, which in turn will definitely assist in generating positive TSR.

Further, it is also to be noted that by using merely two models it is not possible to gauge the level of corporate governance espoused by giant corporations, like those considered for the study in this research paper. There are other financial parameters also which needs to looked into such as, Reported Net Profit After Tax; Goodwill of the organization; Turnover; Economic Value Added; Return on Capital Employed; Earnings Per Share etc. in order to derive the conclusion that a company is really adding to the shareholders wealth or not. So in this case also, merely by looking at MVA and TSR, it cannot be stated with confidence that B Ltd. is a spoil sport. Probably if other mentioned yardsticks were used then the results could have been positive. Further, it needs to be accepted that all the banks considered for study have huge scale of operations. Further, the banks considered for the study and several other listed banks are regulated by Reserve Bank of India and laws like, Banking Regulation Act, Basel Norms and other regulations and so it can be opined that despite negative MVA and TSR of the banks considered for the study in no way their growth potential and sustainability cannot be questioned.

Conclusion

Banking sector being the backbone of any economy plays a crucial role in its development. The shareholders of banking companies are like their guardians who contribute capital at the time of their inception and even during expansion of their operations. As will all businesses, in case of banking companies too, shareholders borne the maximum risk and so they need to be rewarded adequately. Various financial figures, such as Earnings Before Interest, Tax, Depreciation & Amortization; Earnings after Tax; Earnings Per Share; Return on Equity signifies the health of the business and financial health of the investors, but a financial measure that is a metaphor of enhancement in value of wealth of the investors is wealth maximization. However, every yardstick or parameter has both positive and negative aspects and the wealth maximization approach is also not pristine and so an organization needs to concentrate on some of its drawbacks- a) More emphasis on maximizing shareholder value may result into poor or unsustainable business practices. For instance, leading up to the global recession that commenced in the late 2000s, several financial institutions in the U.S. provided mortgages to borrowers who had poor credit in the hopes of making as much profit as possible. While such practices may have led to short-term gains, the resulting mass defaults and foreclosures eventually forced banks to absorb huge losses. In some cases, businesses partake in illegal or unethical activities, such as falsifying financial information, in order to boost shareholder value. Excessive focus on shareholder value is commonly cited as a factor that contributed to the recession that began in late 2007, which some have called the "Great Recession."

Corporate houses whose focal point is maximization of shareholders wealth may tend to lose focus on customers want, or might do things that are not optimal for consumers. For instance, a corporation might choose to cut production costs by using lower-quality parts in its products. While this might boost profits and the price of its stock, it is bad for consumers. Over time, this can blemish the reputation of the company and its products, resulting in the opposite of the intended effect by lowering the value of its stock.

Another negative consequence of shareholder value maximization is that it can hurt employees. The lower a company's costs, the more profit it stands to make if its total revenue is constant, so corporations can benefit from cutting employee benefits and wages. If domestic labour is not cheap enough or not productive enough, businesses can outsource labour to foreign workers who are willing to work for lower wages.

Government regulations and taxes can reduce shareholder value. As result, corporations often contribute money to help certain politicians or political parties, and lobby politicians in an effort to get the government to pass legislation that is

favourable to them. Since corporations often have huge amounts of money at their disposal, they can be far more influential than any single voter. Politicians are sometimes criticized for acting in the best interests of corporations rather than in the best interests of citizens.

But despite several limitations or demerits of shareholder wealth maximization approach it is still of great help to judge the magnitude of corporate governance in various organizations, as every model or theory may have flaws but one needs to see that the advantages outshine demerits .

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Motto

“ सत्यं वद । धर्मं चर ।
इष्टार्थं कुरु त्वाकं. ब्रह्मैव तेन कुरुते कवः ”

Vision

“ To be a global leader in promoting
good corporate governance ”

Mission

“ To develop high calibre professionals facilitating
good corporate governance ”



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