International Conference on Modern Research in Management
16 November 2015
کنفرانس بین المللی پژوهش های نوین در مدیریت و مهندسی صنایع
۲۵ آبان ۱۳۹۴
International Conference on Modern Research in Management and Industrial Engineering

Effect of Environmental Effects on Shareholder Value: Review

Mohammadreza Aslani

Manager, Rah Arvin Machine Company, Tehran, Iran.

Mohammadreza Azimi

Engineer, Rah Arvin Machine Company, Tehran, Iran.

Mreza.azimi@ut.ac.ir

Abstract

The increasing costs for emitting carbon are meant to be stimulation for environmentally friendly business processes. Shareholders will have to deal with this reality. More and more investors demand that companies define their carbon exposure and the risks they face due to associated regulations. These regulations come with uncertainty. The role of business in the climate change issue is addressed in different ways worldwide. Nowadays, climate change is considered an important issue in many of society's domains. In this paper, a brief discussion about the relation between carbon exposure and shareholder value in business management will be presented.

Keywords: Business, Shareholder, Business management, Climate change.

Introduction

Businesses are increasingly demanded to pay for the negative external effects that their operations have on the environment. Depending on the country specific policies, companies have to acquire emissions rights in a trading system or face particular taxations due to their emissions. The internalization of emission costs affects a business's financial performance. Increasing expenses reduce the amount of money which is left for a company's financiers. The investor is the residual claimant of a corporation. This means that after all other financial claimants are paid (e.g. debt holders) and internal investments are completed, investors obtain their share in the company's return; the free cash flow. Investors always decide if they expect to obtain enough return on a certain investment [1, 2]. The investor's expectations of the return on investment of a particular company can be seen as an assessment of all aspects of a certain business and its implications for the future. Including the carbon and environmental strategies of the company. Implicitly, investors hereby decide on the intensity of carbon and/or environmental policies of corporations. From the investors perspective these policies should be in line with shareholder value creation. The investors interest in the return on investment is a key aspect when evaluating climate change policies for business. Solid understanding of the investors position is important for understanding the climate change debate. The relation between climate change and shareholder value in business management is the main subject of this essay [3-5].

Shareholder Value Variation by Global Risks

The Stern Review recently concluded that climate change presents a serious global risk and demands urgent global response [6]. Corporations have an important stake in this issue. As some businesses are among the biggest emitters of carbon -or greenhouse gases-, companies across all industries are demanded to reduce their emission levels. Carbon pricing by trading or taxation is, or will be initiated to stimulate corporations to reduce their emissions. These measures will initially increase the costs for doing business. The more corporations are required to drive down their carbon emissions the more important a firm’s carbon exposure becomes as a management problem. Corporate managers have to align carbon reducing activities with their objective to create shareholder value.

The basic theory behind corporate finance economics argues that the maximization of shareholder value is the most important goal of the corporation. According to this theory, only those investments that benefit the firms' shareholders financially should be undertaken. Corporations create value as long as the value of the inputs is less then the value of the output. Consistent with the basics of corporate finance, companies should try to minimize the costs of the supplies needed for their business and maximize the price of their products and/or services. If managers would pursue such a strategy, shareholders value creation will be optimal [7]. This reasoning is in line with economic theory which implies that in the absence of externalities and monopoly (and when all goods are priced), social welfare is maximized when each firm in an economy maximizes its total market value. Taking into account that shareholders are residual claimants is yet another argument to accept long term shareholder value creation as the main corporate objective [8].

Opposed to shareholder value maximization, stakeholder theory implies that managers must satisfy the competing demands of all stakeholders. Stakeholder theory suggests that companies should pursue not only the interest of shareholders but of everyone affected and involved in the company’s business. For example suppliers, employees and political or social groups [9]. The importance of a stakeholder to the firm's overall strategy should be the crucial factor for management's response to the needs of a particular group.

However, two fundamental assumptions are made in order to obtain value creation as the single objective for the corporation, the absence of externalities and monopolies. Theoretically these assumptions can exist but in reality they cannot. No firm can maximize value if it ignores the interest of its stakeholders. Managers must accept long run firm value maximization as the criterion for making the necessary tradeoffs among its stakeholders. An enlightened vision on shareholder and stakeholder theory specifies long-term value maximization as the firm's main objective and therefore solves the problems that arise from the multiple objectives that corporations face [10].

In this respect corporations can pursue an active environmentally friendly strategy, but they must consider the long run implications. An 'environmentally friendly' company that is not economically successful will sooner or later disappear from the market, and also its beneficial activities for the environment [11].

The increasing costs for emitting carbon are meant to be stimulation for environmentally friendly business processes. Shareholders will have to deal with this reality. More and more investors demand that companies define their carbon exposure and the risks they face due to associated regulations. These regulations come with uncertainty. The role of business in the climate change issue is addressed in different ways worldwide. Without universal standards for carbon emissions policymakers at all levels are coming up with their own regulations. In this sense businesses are affected different worldwide. There seems to be increasing consensus among shareholders that the way in which a company manages its carbon exposure can create or destroy shareholder value.

Conclusions

The role of sustainability thinking in supporting business objectives typically relies on how it supports current performance and influences shareholders' expectations of future performance of the business organization. Shareholders evaluate current performance by how well the business is executed and delivers its short-term results. Current performance is generally more tactical and operationally-focused. The organization's ability to control costs and future liabilities and generate short-term profit is among those factors that affect current performance.

The alignment of environmental aspects that affect shareholder value creation through current and future performance provides the business case for addressing sustainability issues

References

[1] Friedman, M. 13 September 1970. The social responsibility of business is to increase its profits. *New York Times Magazine* .

[2] Malkiel, B. G. and Quandt, R. E. 1971. Moral issues in investment policy, *Harvard Business Review* 49(2):37-47.

[3] Cornell, B. and Shapiro, A. C. March 1987. Corporate stakeholders and corporate finance. *Financial Management* 16(1):5-14.

[4] Wartik, S.L. and Wood, D.J. (2001). International Business and Society. Oxford: Balckwell Publishers.

[5] Jensen, M.C.; Meckling, W., 1976. Theory of the firm: managerial behavior, agency costs, and ownership structure. *Journal of Financial Economics 3*, 360–395.

[6] Stern, N. (2007). The economics of climate change: the Stern review. Cambridge: Cambridge University Press.

[7] Koller, T., Goedhart, M. and Wessels, D., 2005. Valuation: Measuring and Managing the Value of Companies. McKinsey and Company, Inc. 4th ed., NY Wiley & Sons, Inc.

[8] Ross, S. A., Westerfield, R. W. & Jaffe, J. (2005). Corporate Finance. New York: McGraw-Hill.

[9] Wartik, S.L. and Cochran, P.L. 1985. “The evolution of the corporate social performance model.” *Academy of Management Review* 4, 758-769.

[10] Jensen, M.C., 2001. Value Maximization, Stakeholder Theory, and the Corporate Objective Function. *Journal of Applied Corporate Finance, Fall 2001.*

[11] Schaltegger, S. and Figge, F. “Environmental Shareholder Value :Economic Success with Corporate Environmental Management**”** *Eco-Management and Auditing.* Volume 7, 29–42 (2000)