Rationale for shareholder wealth maximization in investment report example

Business, Company

In capital budgeting, the ultimate condition underlying any investment decision in whether or not it maximizes the wealth of the shareholder. It might be of interest at this point to note that it is shareholders and not any other providers of capital who are considered in the investment decisions. The best rationale for the maximization of shareholder wealth is the ownership claim that shareholders have on any company. Essentially, shares represent ownership, and thus it follows that any business decisions should be in the best interests of the owners. Investment decisions should thus all be geared towards improving the financial position of the owners always, and if that if not followed, it means that the owners of the company do not have their best interests being taken care of by the company.

Another rationale for shareholder wealth maximization is the residual claim that shareholders have on the assets of the company. This is because as a company expands, it sometimes seeks financing from other sources other than shareholders, and more often than not, these financiers have priority in the claims to the company's assets. This means that the shareholders would be the last to be considered during a wind up by the company. It thus follows that in making investment decisions, the management should consider always to improve the position of the shareholders in relation to the other financiers of the company such as bond holders. Such a decision thus can only be geared towards maximizing shareholder wealth to ensure that after meeting all the other claims on the assets of the company, the shareholders have the maximum return (De Soto, 2000).

Companies that follow the wealth maximization principle always seek the most efficient method possible of conducting business activities. In practice,

this implies that the most efficient methods of production are employed to produce the highest quality of products or services for customers. By extension, this means that the best interests of customers are also met in the process, and the company is able to reap the maximum benefit from its investment decisions which are meant to maximize the shareholder wealth (De Soto, 2000).

The goal of shareholder wealth maximization is the ultimate goal in the workings of a company. By seeking to have the best position for the shareholder, the company is able to meet the objectives of all the other stakeholders in the most efficient manner.

Other than shareholders, the company has to consider in the formulation of its goals other stakeholders such as the employees, customers, suppliers of short term and long term financing and the society in which the company operates. The decisions made in capital budgeting will ultimately have an effect on these stakeholders, either directly or indirectly and it is thus prudent to ensure that they are considered in the making of investment decisions.

Environmental costs and benefits in investment appraisal

Environmental considerations in investment appraisal pose a challenge since they basically require that a company use its resources in what is considered unprofitable. In effect, this may drive away investors from the company since it may imply that the return that the shareholders can expect in such an investment would be lesser than if they invested in a company which does not bear environmental costs. However, due to increased social consciousness regarding environmental matters, it is expected that

companies include measures meant to protect the environment in their activities, and thus in making investment decisions, it now important to factor the cost of these activities. Various regulatory frameworks also require the disclosure of environmental costs that a company incurs, and this also includes the projected costs to be incurred when making investment decisions (Schemph, 1998).

For Tumbuhan plc, the inclusion of environmental costs and benefits would involve several processes. The first will be an evaluation of the regulatory framework governing the proposed investment. This is because it is important to consider if the investment is within the regulations provided. An assessment of the probable future changes in the provisions of such changes is also important to ensure that the investment does not face legal hurdles in the future due to changes in regulatory framework. This will enable the company to avoid potentially costly situations in the future.

Since investment appraisal involves making projections, an objective method of determining the projections of the costs and benefits of the investment should also be determined. This will be integrated in the investment appraisal and the proper considerations on them made. These will be projections on the costs such as hazardous waste testing and monitoring, waste water treatment and disposal, environmental fines and penalties, costs of construction of environmentally friendly plants and other related costs. The financial benefits to be projected will be in terms of the revenues that will be recognized directly as a result of the environmental measures taken. These will then be used in the investment appraisal (Schemph, 1998).

In including environmental costs and benefits in investment appraisals, many stakeholders are affected by such decisions. Principal of these are the shareholders. This is because such decisions tend to have more costs than benefits, and most of the time the shareholder wealth is not maximized to the same level as when environmental considerations are not made. Shareholders may therefore end up losing on potential gains if consideration for the environment is included in investment appraisal (Schemph, 1998). The management of the company is also affected by inclusion of environmental costs in investment appraisal because it is upon them to prove to the shareholders that such an investment is in their best interests. This may not always be the case, and conflicts between the shareholders and the management may occur (Schemph, 1998).

The greatest beneficiaries of environmentally conscious investments are the customers. This is because they are able to have access from the company products which are of the best environmental quality. The associated social costs which may occur if environmental considerations are not made are also avoided (Schemph, 1998).

Conclusion

In investment appraisal, environmental costs are important and should be given serious consideration. The potential harm to a company’s returns if such considerations are not made may be colossal, and the best way to avoid such is by integrating environmental costs in the capital budgeting process. This should be carried out in the most objective manner to ensure that realistic measures are undertaken to make projections on such costs.

The existing regulatory framework should also be considered in such investment decisions and their implications in the future of such investments carefully evaluated.

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