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ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ASPECTS AND SUSTAINABLE VALUE CREATION IN COMPANIES: AN INDIAN PERSPECTIVE

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ABSTRACT

Sustainability concept introduced in the corporate finance is generally used to refer to a model of tapping different sources of finance and making investment decisions at the corporate level by taking due account of environmental, social, and governance (ESG) considerations leading to increased longer-term investments into sustainable economic activities and projects. The concept of sustainability in corporate finance has evolved over years on the lines of principles followed by cooperative and mutual sector and adopted in the mainstream corporate sector and its reflections can be found in fragmented form of existing mandatory corporate social responsibility (CSR) spending and requirement of furnishing corporate sustainability reports.

Modern companies are increasingly adopting to the goal of long-term sustainable value creation rather than just maximizing profit or shareholders' value. The long term sustainable value creation objective at corporate level attempts to integrate broader social and environmental aspects into the financial value creation fold for contributing towards the ultimate objective of transitioning towards sustainable economy which is in conformance with global practices followed by companies in different developed countries of world. Thus, sustainability in corporate finance aims at achieving the objective of sustainable value creation assimilating within its fold interests of all stakeholders in place of erstwhile objective of profit maximization and the modern practice of shareholders' value creation. It has been observed that the popular shareholders' value creation model has held companies back from adopting sustainable business practices in design and implementation of the corporate long term investment strategy in sustainable economic activities and projects. It may be due to increasing awareness among shareholders about social and environmental concerns compelled by rising trends among institutional investors for investing in companies adopting sound ESG practices. The Sustainable value creation approach ranks interests of all stakeholders equally. Such a move to the stakeholder model requires new rules for corporate governance and decision-making on corporate investments to deal with the various interests of current and future stakeholders.

This study attempts to tender a general picture about different emerging concepts related to ESG and sustainable value creation in corporate finance and how it is going to impact companies in India based on evidences obtained in different countries of the world.

KEYWORDS: Sustainable Finance, Sustainability in Corporate Finance, Environmental, Social and Governance (ESG) Aspects, Shareholders' Value Creation, ESG Disclosures, Sustainable Value Creation, Indian Perspective

INTRODUCTION

The erosion of natural capital caused by manmade reasons poses existential threats to humanity at large and is gradually harming national and global prosperity amidst unpreparedness of the political and economic systems for responding to that risk. Increasing instances of natural calamities have caused huge loss of precious human lives and property in recent past and such casualties have become more frequent in recent times than ever before. Achieving higher rate of economic growth has now become a compulsion for every nation and commands a central place in framing of various state policies in their quest for alleviation of poverty and bringing improvement in standard of living of people residing in that country especially poor and downtrodden sections of society. Economic growth entails using various natural resources in production of goods and services but when it takes the form of race causing over-exploitation of natural resources then it results in inflicting severe damage to natural environment due to excessive emission of greenhouse gases. Gradually, the world community has started realizing the huge cost that humanity is paying for environmental damage and so there is daunting challenge before every country to cut down carbon emission and release of greenhouse gases but none wants to compromise on their growth agenda. A recent report suggests that India lost nearly \$69 billion in 2019 alone due to climate change related events which is comparatively much higher than losses of \$79.5 billion during the period 1998-2017. The Global Climate Risk Index 2021 has ranked India 7th in the list of most affected countries in terms of exposure and vulnerability to climate risk events. India has also gradually started facing continues climate change related crisis like extreme heat, temperature, scanty monsoon, floods and rising sea levels and its impact on overall macro-economic and social environment like never before. The Reserve Bank of India (RBI) has recently estimated that India could lose up to 4.5 percent of its GDP because of climate change related risks by 2030 due to lost labour hours from extreme heat and humidity in weather. Corporate sector is to held accountable to a large extent by the governments for bringing suitable reforms in their production technology and processes to make production of goods and services environment friendly to minimize adverse effect on natural environment. Further, corporate sector needs to join hands with governments for helping achieve societal concerns of modern times confronting Indian society.

Sustainability in corporate finance is generally used to refer to a model of tapping different sources of finance and making investment decisions at the corporate level by taking due account of environmental, social, and governance (ESG) considerations leading to increased longer-term investments into sustainable economic activities and projects. While India places a higher priority on economic development needs of the nation to face economic challenges but equally it recognizes environmental challenge too with a globally aligned policy for reduction in emission of greenhouse gas (GHG). The concept of sustainability in corporate finance has evolved over years on the lines of principles followed by cooperative and mutual sector in the mainstream corporate sector and its reflections can be found in fragmented form in existing requirement of stipulated corporate social responsibility (CSR) spending and corporate sustainability reports. Sustainability in corporate finance has hitherto existed for quite a long time in fragmented form by the names of philanthropic finance, venture philanthropy, micro-finance, green-finance and green banking but got consolidated in formal finance literature post-2015 period primarily due to the United Nations establishment and propagation of Sustainable Development Goals (SDGs) and its subsequent adoption and enforcement at corporate regulatory level by sovereign Governments across the world in form of a plethora of competing reporting standards and principles (for example, the UN Principles for Responsible Investment [PRI], the Global Reporting Initiative [GRI], and the Social Accounting Standards Board [SASB] and limited regulation around disclosure (though see recent EU and UK regulatory models).

Modern companies are increasingly adopting to the goal of long-term sustainable value creation, which integrates financial, social and environmental value for contributing towards the objective of transitioning towards sustainable economy. Thus, the sustainable concept in corporate finance aims at achieving the objective of sustainable value creation in place of erstwhile objective of profit maximization and shareholders' value creation. The shareholders value creation model is holding companies back from adopting sustainable business practices. An enhanced shareholder view recognizes that it is instrumental to treat the other stakeholders well in order to preserve long-term shareholder value. Sustainable in corporate finance offers an alternative view by broadening the objective of the corporate finance towards optimizing the integrated overall value of companies combining the financial, social and environmental value. This approach ranks interests of all stakeholders equally. Such a move to the stakeholder model requires new rules for corporate governance and decision-making on corporate investments to deal with the various interests of current and future stakeholders.

This study attempts to tender a general picture about different emerging concepts related to sustainability in corporate finance and sustainable value creation and how it is going to impact companies in India based on evidences obtained in different countries of the world.

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REVIEW OF LITERATURE

Some of the related previous works in the area is enumerated below to build necessary ground for this work as well as future studies that can be proposed to be carried out in the field.

Christensen et al. (2019) in their study based on broad literature review of accounting and finance studies shows that firms' ESG disclosure varies widely, making it impossible to evaluate ESG practices impartially. If ESG data is improved, capital markets could gain liquidity, cheaper capital costs, and more effective resource allocation. CSR data may help investors predict cash flows and assess company risk.

A meta-analysis of 60 review studies that combine more than 2200 unique primary studies conducted by Friede et al. (2015) documents that 90% of academic studies find a non-negative relationship between ESG and financial performance (also see e.g., Orlitzky, Schmidt, and Rynes, 2003; Flammer, 2015; Krueger, 2015).

Choi et al. (2020) study found that as temperatures rose, so did the volume of Google searches on climate change. The data analysis showed that companies with high carbon emissions have a lower stock market performance than companies with low carbon emissions when temperatures rise above average. Individual investors are more inclined to sell carbon-intensive businesses under these situations than institution.

Studies by Bergman (2018) and Cleveland and Reibstein (2015) have found that the need to reduce harm to the environment caused by fossil fuel emissions has led to calls for divestment from fossil fuel activities, and a shift to investing in low-carbon projects and activities that protect the environment in a sustainable way.

A Study by Hart and Zingales (2017) challenges the prevailing idea that externalities, like charity, environment protection etc. may be outsourced to the shareholders. They make a distinction between the concept of shareholders' value creation which aims at maximization of financial value only and on the other hand the stakeholders' value approach that incorporates social and environmental externalities within the fold of shareholders' value. An important assumption in their model is that these externalities are linked to a company's operations. So, companies face a choice in the degree of sustainability in their business model. The mechanism in Hart and Zingales (2017) to guide that choice is voting by prosocial shareholders on corporate policy.

Schramade (2016) study has stated that the internalization of externalities is a dynamic process and that what is financially viable now can be loss making in the future (and vice versa). Some externalities are already in the process of being internalized through best business practices at some companies such as energy and material savings in the production process and nurturing of an inspired work force. Further, externalities may be internalized in the future under pressure from government interaction through regulatory and tax legislations, societal pressure and technological developments, such as low cost solar and wind energy. Companies can anticipate and incorporate externalities by connecting the relevant social and environmental dimensions to their business model making their business model well prepared to face future transitions.

Studies by Khan et al. (2016) and Schoenmaker and Schramade (2019) have found that the materiality (or lack thereof) of the social and environmental dimensions is highly context specific. It varies according to the nature of industry and also within industries, depending on the specific company's business model and local conditions.

Studies by Jensen and Meckling (1976) and Berk and DeMarzo (2017) have stated that adoption of sustainable practices by companies raises fundamental question in the corporate finance about the objective of corporation in terms of profit maximization and shareholders' value maximization because both these objectives are holding companies back from adopting sustainable business practices.

Jensen (2002) held that an enhanced shareholder view recognizes that it is instrumental to treat the other stakeholders well in order to preserve long-term shareholder value.

Objectives of the Study

The present study aims at fulfilling the following objectives:

i) To tender a general picture about different emerging concepts related to ESG aspects and sustainable value creation in corporate finance.

ii) To develop an understanding about how it is going to impact companies in India based on evidences obtained in different countries of the world.

Data and Research Methodology

This study is primarily based on review of existing literature published in journals of repute. The research paper is descriptive in nature. The data is collected from secondary sources collected through published sources such as reports, journals, research articles, and websites.

Sustainability Concept in Corporate Finance

Sustainable concept in corporate finance aims at fulfilling the objective of long-term value creation for the company through optimization of its financial, social and environmental value in the long term in conformity with the sustainable economic model for growth. However, current business practices

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are still too narrowly focused on maximizing short-term financial returns despite proclaiming their objective of maximizing the long-term shareholders' value. It can be observed that stock price performance are used as a central performance measure for shareholders' value creation which is based on operation of efficient market hypothesis primarily in the short term and this very short-termism in assessment prove to be an obstacle to adoption of sustainable practices by corporates. An alternative to shareholders' value creation objective has gradually been taking shape in form of optimization of the total or integrated value combining therein the financial, social and environmental value. The integrated value approach places equal importance satisfying interests of current and future stakeholders. Such a move to the stakeholder model requires new rules for corporate governance and decision-making on corporate investments to deal with the different interests. The integrated value approach uses the net present value (NPV) rule for measurement of value creation because it is capable of incorporating the social and environmental dimension in its calculation. Contrary to the efficient market hypothesis, the adaptive markets hypothesis assumes that market efficiency depends on an evolutionary model of individuals adapting to a changing environment. This can explain why new risks, such as carbon risks, are not yet fully priced in. Possible solutions to counter short-term market practices are a more long-term orientation for the reporting structure (moving away from quarterly reporting) and the pay structure for executives (deferred rewards and clawback provisions). The following table depicts changing paradigm of corporate finance after introducing sustainability aspect within its fold.

Table 1: Contours of an alternative paradigm for corporate finance

Dimension	Old paradigm	New paradigm
Objective of corporation	Profit maximization/Wealth Maximization	Purpose driven
Control of the corporate	Shareholders	Stakeholders
Decision-making	Net present value based on financial factors (Max FV)	Long-term value creation Potential (Max IV = FV+SV+EV)
Reporting	Financial	Financial & extra-financial
Compensation	Stocks/options	Financial and sustainability targets
Securities pricing	Efficient markets hypothesis	Adaptive market hypothesis
M&A appraisal process	Anti-competitive and political	Societal cost-benefit analysis

Note: FV = Financial Value, SV = Social Value, EV = Environmental Value; IV = Integrated Value.

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Value Creation

Value can be quantified on the basis of number of factors such as quality of informations, perception, control, time horizon, uncertainty and risk appetite. These are the factors which create the individual's perspective on the value of a particular company at any given time. But the most important determinant of value creation happens to be shareholder's expectations about generation of future free cash flows by that company. Value is a subjective statement of beliefs about the future and represents a perception about the company's prospects (Knight, 1998). Value has existed as a concept since time humanity has conducted trade and accumulated capital and wealth. It has been the consistent measurement used by those with freedom of choice to trade, invest and preserve capital.

Definition and Meaning of Shareholder Value

Value creation has become a buzzword in business and finance literature for last few decades. The total economic value of a firm is the sum of value of its debt and equity. This value of the business in the context of a company is known as corporate value while the value of its equity is popularly known as shareholder value (Rappaport, 1998; p.186). Thus, in summary:

Corporate value = Debt + Shareholder value

In the above mentioned formula the debt portion represents the sum total of the market value of debt, unfunded pension liabilities and the market value other claims such as preferred stock. The corporate value is the total value of a firm. The above equation can be rearranged for shareholder value as under:

Shareholder value = Corporate value - Debt

Thus, determination of the shareholder value is dependent on corporate value which according to Rappaport (1998) consists of the following three components:-

i) The present value of cash flow from operation during the forecast period;
ii) Residual value which represents the value of the business attributable to the period beyond the forecast period; and
iii) The current value of marketable securities and other investments which can be converted into cash and are not essential to operating the business.

Shareholder value is defined as being the difference between the corporate value and debt where the corporate value is the sum of the future free cash flows discounted at weighted average cost of capital (WACC) (Black and Gilson, 1998). The discounted cash flow approach (DCF) assumes that it is more of the cash flows rather than profits which determine a company's stock price. The free cash flows consist of individual cash flows for each year of the growth duration or competitive advantage period and the residual value. Cash flow is named as free as it is available for distribution to shareholders at a given point of time. Shareholder value is interchangeably used for value of equity of a firm or its market capitalisation. The market capitalization of a publicly traded firm is highly transparent and it is the number of shares listed on the stock exchange multiplied by the average price per share (Black

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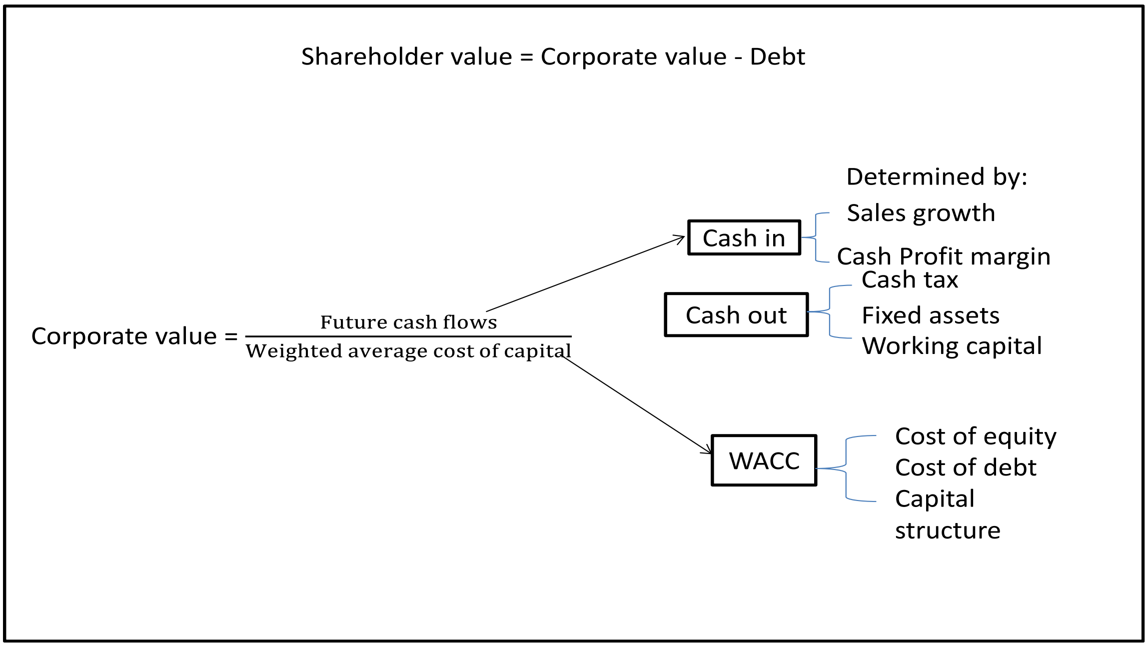
and Gilson, 1998: p.296). The basic consensus amongst various authors on the definition of shareholder value is that it is the present value of all free cash flows to the real owners during the forecast period including the amount distributed when the company is sold or liquidated. The fundamental principle of shareholder value creation is that a company only adds value for its shareholders when its equity return exceeds equity cost. The stakeholders of a firm are now more concerned about its cash flows.

Figure 1: Shareholder Value



Equity shareholders are concerned about firm's cash position to ensure payment of dividend; managers are concerned about cash generation from current business and funding to maintain the status quo or growth; suppliers are concerned about the firm's potential to pay back extended credit; analysts and investors are concerned about a firm's potential for cash generation through growth; employees are concerned about the firm's ability to pay wages and to produce cash to support its current and future operations. Despite its inherent volatility and negative values, the market price to cash-flow multiples has become popular with Wall Street analysts, and, with the ascent of hedge funds, investors pay more attention to cash flows. The deterministic discounted cash flow (DCF) analysis is well established in capital budgeting and as a financial and economic tool for evaluating an investment feasibility (Carmichael and Balatbat, 2008). Further, investors and analysts believe that, compared to other accounting measures, cash flow is relatively free from manipulation. Therefore, the CEOs of vibrant companies have started increasingly focussing on cash flows for long term value creation, confident that stock's market price would eventually reflect their efforts. Companies create value by investing capital at rate of return (ROIC) that exceed their cost of capital (WACC). The more capital they can invest at attractive rate of return, the more value they will create so long as the return on capital exceeds the cost of that capital. Growth is another important part of the value creation process which results from sustaining a long competitive advantage period.

Shareholders' value vis-a-vis value creation for other Stakeholders:

The critics of the shareholder value management model argue that it only attempts to maximize value for the shareholders and not of other stakeholders. Therefore, they forwarded the concept of stakeholder model as best alternative as it aims at satisfying all stakeholders. The stakeholder model argues that managers should balance the interests of all stakeholders, both current and future. In the context of sustainability, the problem of value creation requires reframing the business value in a way that includes all stakeholders. In other words, the concept of sustainable value expands the value creating universe to include all key stakeholders. The CEOs of modern firms oriented to sustainable corporate finance are forced to make decisions consistent with desirable environmental, social and governance outcomes driven by powerful market incentives like work place safety, customer satisfaction, etc. A company can survive in the long run only by satisfying all its stakeholders who have financial interest in the company. Through time, the main business goal of companies has changed and the attention has moved from the owner towards the providers of capital meaning all stakeholders (shareholders, investors, creditors etc.). Here, managers should identify key stakeholders groups and assess the company's economic, social and environmental impacts on these groups, which of course requires its own set of metrics. These can be done through dialogues with stakeholders such as employees and local communities about the company's impacts. Magill, Quinzii and Rochet (2015) suggest that this under-investment problem can be alleviated if firms are instructed to maximise the total welfare of their stakeholders rather than shareholder value alone (stakeholder equilibrium). The stakeholder equilibrium can be implemented by introducing new property rights (employee rights and consumer rights) and instructing managers to maximise the integrated value of the company (the value of these rights plus the shareholder value).

The corporate sector can thus play an important role in achieving the UN sustainable development goals through long-term value creation. The concept of long-term value creation means that a company aims to optimize its financial, social and environmental value in the long term (Dyllick and Muff, 2016; Tirole, 2017). The optimization requires a careful balancing of the three dimensions whereby interconnections and trade-offs are analyzed but none should deteriorate in favour of the others.

Impact of Environmental, Social and Governance (ESG) Aspects in Corporate Finance on Indian Companies

The Paris Agreement introduced the concept of sustainable finance to society and it is a legally binding

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international treaty on climate change. It was adopted by 196 countries at the UN Climate Change Conference (COP21) in Paris, France on December 12, 2015 but it entered into force on November 4, 2016. However, only a few countries have started working on it and India is one of them. Today, sustainability is not only a choice but it has become a necessity driving various company decisions in India. The Business Responsibility and Sustainability Reporting (BRSR) regulation issued by the Securities and Exchange Board of India (SEBI) in 2021 was initially voluntary for FY 2021-22 to encourage companies for early adoption but from FY 2022-23 onwards it has been made mandatory for top 1000 companies to make ESG disclosures. The BRSR is grounded in the National Guidelines on Responsible Business Conduct (RBC Guidelines) which aligns with leading international standards, including the UN Sustainable Development Goals, the Paris Agreement and the International Labour Organisation (ILO) Core Conventions. The importance of ESG considerations in business has gained significant attention globally, driven by increasing awareness of environmental issues, social inequalities and corporate governance failures (Eccles & Serafeim, 2013; Linnenluecke, M. K., 2022). It can be observed that a similar awakening is taking place within the corporate landscape in India too. It has been found that companies operating in India are increasingly recognizing the imperative nature of aligning their strategies and operations with ESG principles (Maji, S. G. & Lohia, P., 2023). This can be considered to be a significant shift and transformation in the Indian business environment. In order to ensure that companies focus on ESG issues that are prominent for their specific industry and operations, SEBI encourages companies to conduct a materiality assessment to identify ESG factors that are most relevant to their business (Debnath, P. & Kanoo, R., 2022). This approach ensures a structured framework for ESG reporting and integration, including guidelines on content, format, and disclosure requirements in the BRSR.

A strategic ESG framework helps in evaluation of a company's economic, climate, and social initiatives implications on society and the environment. Further, the ESG Framework are useful for planning and strategy formulation at corporate level because each company is faced with different types of economic, social and environmental conditions and industrial hazards. In addition to this the ESG framework helps shareholders and investors make appropriate choices for making investment because they have become more aware of environmental and societal concerns. The desire to attract global investors invest into companies in India has gradually evolved into a driving force. Indian companies seeking foreign investments and access to international capital markets are aware of the importance of proving outstanding ESG performance (Bodhanwala, S., & Bodhanwala, R., 2019). ESG factors are becoming more important to institutional investors around the world when making investment decisions.

Environmental Sustainability

There are different types of environmental concerns that need to be addressed by companies to preserve natural environment from deterioration including climate change policy, use of renewable sources of energy, waste disposal, natural resource like air, water etc. conservation, and animal welfare. The ESG framework helps to assess the company's response to different environmental issues. Indian companies have gradually started taking a range of environmental protection initiatives to contribute towards the cause of sustainability, including carbon emissions reduction, renewable energy adoption, waste management, and resource conservation. Notable Indian companies contributing significantly to this area are Tata Motors, Tata Steel, Tata Power, Reliance Industries, Mahindra & Mahindra, Infosys, ITC Limited, HUL (Hindustan Unilever), Larsen & Toubro (L&T) among others.

Social Initiatives

Companies operate in a society and get reward in form of profit by providing goods and services needed by the society and so it is very important for businesses to take care of their social concerns faced the society to maximize their value creation in the long run. They need to design an appropriate corporate social responsibility (CSR) strategy to respond to their social environment and contribute to cause of finding solutions to various social challenges. Today, businesses practice 'socially responsible investing (SRI)' while making investment in different projects emphasizing on the social aspects of ESG by linking organization's external and internal stakeholders. SRI aims attracting and involving active investors in businesses who are supportive for promoting moral and socially cognizant ideals such as diversification, inclusiveness, social objectivity, social justice, and ethnicism in the workplace, as well as the difference between sexual and gender discrimination. Social initiatives are concerned with meeting mandatory corporate social responsibility (CSR) obligations integrated with company broader policy objectives promoting community involvement and healthy labour practices. Many companies have taken a wide variety of CSR initiatives under legal obligation as well as on voluntary basis demonstrating their commitment to addressing urgent social concerns in India and making a constructive contribution to society. Notable companies who have made significant contribution in this area include ITC Limited, Tata Group through the Tata Trusts, Tata Consultancy Services (TCS), Infosys through its Infosys Foundation, Reliance Industries (RIL), Hindustan Unilever Ltd (HUL), Mahindra & Mahindra among others. These companies are not only profit-seeking entities, but also active promoters of social improvement, focusing on initiatives that promote positive change. Through subsidy programs, affordable health care, sanitation, hygiene campaigns, sustainable procurement practices and supporting girls' education, they exhibit a holistic approach to corporate social responsibility that transcends commercial interests and ultimately fostering a more equitable and prosperous society.

Governance Initiatives

Corporate governance is very important consideration for companies in their quest to perform better

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and so shareholders and investors ensure that businesses do not appoint board members and top executives with conflicts of interest or that they would not participate in offering donations to political parties to gain preferential treatment or engage in criminal activity. The purpose of incorporating ESG governance standards into a business ensures fair adoption of appropriate accounting policies and methods by top executives who have been selected keeping in mind honesty and diversity who can be held accountable to its shareholders. Corporate Governance in India has undergone significant reforms in recent years through amendment in the Companies Act, 2013 bringing enhanced transparency and accountability. Important changes include the mandatory appointment of independent directors, the strengthening of audit committees, and stricter disclosure requirements. Moreover, the Securities and Exchange Board of India (SEBI) has introduced several changes in listing regulations for listed companies such as the separation of the roles of chairman and CEO, the establishment of risk management committees, and the enhancement of the role of independent directors. In addition to this, the establishment of the National Financial Reporting Authority (NFRA) further reinforces governance by overseeing financial reporting quality and auditor independence. Board diversity has emerged as a pivotal aspect of Corporate Governance in India.

CONCLUSION

The sustainability concept in corporate finance resets the goal of the company's financial policy as promoting sustainability for taking care of future generations. This choice results in a multi-attribute approach to financial policy and theory. This may make financial modeling even more complex but certainly encourages adoption of an empirical approach based on market process from which normative human and economic guidelines can be deducted. Further, it can be stated that measuring economic results based on institutional and behavioral rules is more important than prediction of market behavior. Thus, sustainable corporate finance strives for triple bottom-line performance measurement with human actors that opt for maximizing multi-dimensional preference functions. This approach is now more acceptable for modern companies in a globalised world that are owned by different stakeholders spreading beyond borders of a nation, rather than by shareholders alone. The sustainability concept of corporate finance aims at achieving long term financial goals through reintegration of social values into economic theory reflecting a credible and reliable picture of the underlying company. There are several measures undertaken in India for early adoption of ESG principles by the corporate world which has helped it position itself in a good place to compete on the global level in a rapidly changing business world where sustainability and responsible business practices are of paramount significance. The consideration and adoption of Environmental, Social, and Governance (ESG) principles in India highlights a transformative shift in the corporate sector. Although, Indian companies are taking comprehensive ESG initiatives, addressing environmental challenges, engaging in meaningful social activities, and enhancing governance practices but still there are several formidable challenges that persist.

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