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Capital Budgeting and Sustainable Enterprises: *Ethical Implications*



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Abstract

The increase in the scale of social, environmental, and economic problems has led to numerous questions and suggestions about the role and responsibilities of business in society with universal calls – emanating from a wide range of stakeholders – for companies to play a greater role in mitigating or solving these issues. Capital budgeting is considered as a possible area in which firms can contribute to mitigating these various socio-economic problems, but such projects must be assessed with new techniques that incorporate not only financial measures, but social and environmental metrics as well. This discussion thus focuses upon the sustainable framework and the development of sustainable enterprises which, arguably, would not be achievable without a values-based leadership approach.

Introduction

The global business community is typically portrayed as the primary culprit of social, environmental, and economic instability. This responsibility has been made even more specific with the United Nations' Global Compact which aims to make it possible for companies universally to participate in and contribute to tackling various socio-economic problems such as human rights, labour exploitation, the environment, and corruption, as outlined in its ten principles (Kanji & Chopra, 2010). It is also clear that planetary survival depends upon long-lasting and meaningful amelioration of these problems. However, this is possible only with significant active participation of the private sector with businesses that



demonstrate ethical behavior consistent with good corporate citizenship. It also implies that businesses must then be managed with principled leadership.

This emergent role that stakeholders expect from business further underscores the complexity of the relationship between business and society, and intensifies the ongoing battle between maximizing shareholder value and providing benefits to those entities impacted by company operations (Haugh and Talwar, 2010). Emerging from these issues are new paradigms intended to redefine the purpose of business in society with advanced methods of measuring a company's social, environmental, and economic performance — *Triple Bottom Line* (3BL) accounting (Brown et al, 2006). In this manner, a corporation's success is not just measured by the traditional financial bottom line, but also by its social, ethical, and environmental performance (Norman and MacDonald, 2004). It is in this context that capital budgeting can arguably contribute to mitigating some of these socio-economic issues. The following are discussions positioned within the framework of sustainable development and the development of sustainable enterprises.

Enterprises, irrespective of size, are the principal source of economic growth and employment creation and are at the center of economic activity and development in nearly all societies. They serve as vital stimulants that bring about change and progress by ensuring that economies remain dynamic, innovative, and competitive (Baumol, 2002). Given their central role in wealth creation and development, enterprises need to therefore ensure that their core business activities continue to add value and are undertaken efficiently and effectively (Buckley, Salazar-Xirinachs, and Henriques, 2009). This is the basis in which the concept of the sustainable enterprise is introduced. It is directly linked to the general approach to sustainable development articulated by the World Business Council for Sustainable Development (WBVSD) as “forms of progress that meet the needs of the present without compromising the ability of future generations to meet their needs” (WBCSD). This approach to development is holistic, balanced, and comprehensive, requiring the integration of all three pillars of development: economic growth, social progress, and environmental preservation and stewardship.

Unlike the traditional perspectives which view enterprises in terms of linear input-output relationships focused solely on maximizing short-term economic value, an integrated approach to sustainable enterprise incorporates a more long-term view. While business enterprises are economic entities attempting to pursue profit through fair competition, many are concomitantly providing needed goods and services through principled processes and leadership. A sustainable enterprise, therefore, has an advanced awareness of the close link between social and corporate development and is expected to create a sustainable society through business activities that comprehensively address economic, environmental, ethical, and social issues (Buckley, Salazar-Xirinachs, and Henriques, 2009). This holistic and integrated approach can therefore be incorporated into capital budgeting.

Measuring Economic Performance

Organizations use accounting systems as their main measure of financial performance. The accounting system collects and aggregates financial information for use by internal and external decision-makers including managers, investors, regulators, lenders, bankers, and the public proper. Schempf (1998) contends that accounting systems influence behavior



and so affect management across departments, organizations, and even countries. Accounting information systems are particularly strong behavioral drivers especially where the traditional financial bottom line is the *raison d'être* of the business enterprise. If environmental and social issues are considered critical factors in daily business management decisions, they then need to be incorporated into the accounting systems of organizations (Schempf, 1998).

As previously cited, traditional financial and cost accounting systems are mainly designed to assess economic performance. In consideration of the urgent call for sustainable development and sustainable enterprises, companies need to include social and environmental measurements when evaluating their performance. Nonetheless, while social and environmental information might be available to some organizations, there are still challenges in effectively linking such information to economic variables (U.N. Division for Sustainable Development, 2001). Consequently, the economic value of natural and social resources as assets is largely ignored. As a result, businesses would need to find feasible methods to incorporate techniques and practices that account for the social and environmental costs of their decisions.

Capital Budgeting

The chief determinant of the growth of a company is premised upon the investment it makes today (Higgins, 1998). As companies seek to maximize shareholder value through economic performance, they must manage their inputs in order to optimize their outputs. This requires decision-makers to carefully evaluate how best to invest each business's resources. A company would want to list the projects and investments it wishes to undertake and decide on which it would accept through a process of capital budgeting (Beck and DeMarzo, 2009). Congruently, capital budgeting is a critical component in a company's bid to stay competitive, viable, and sustainable, as it helps to inform the pivotal financial decisions that will optimize corporate resources in the long run. The traditional quantitative methods for assessing capital projects involve comparing the cash inflows and outflows so as to determine the overall net cash position from undertaking the project. The most common methods used are:

THE PAYBACK PERIOD – This method calculates the time taken for the initial capital outlay to be recouped by the investor. Discounting cash inflows at the cost of capital is referred to as a *discounted payback*.

NET PRESENT VALUE (NPV) – This method compares the discounted cash inflows with the cash outflows for the project. The factor used to discount the cash flows is the cost of capital. A project is considered favorable if the discounted cash inflows exceed the cash outflow.

INTERNAL RATE OF RETURN (IRR) – This is the discount rate at which the NPV is rendered to be zero. A project is said to be favorable if the IRR exceeds the company's required rate of return or hurdle rate.

BREAKEVEN ANALYSIS – This is usually used as complementary to the above methods and used mainly to test the sensitivity of certain variables in the project. The idea is to determine the level of sales required before the company would generate a net income.



While these methods are very useful in assessing the economic viability of a project from the perspective of the financiers, they are weak in assessing the social and environmental cost/impact of the project. These conventional cost accounting techniques as well as aggregate environmental and non-environmental costs in overhead accounts result in latent expenses “hidden” from management. Decision-makers are thus unable to adequately appreciate the significance or value of these non-financial variables with these conventional methods. In fact, there is substantial evidence that management tends to underestimate the extent and growth of such costs (United Nations Division of Sustainable Development, 2001). Ditz, et al (1995), estimates that environmental costs can range from between five to twenty five percent of the total cost of business activities. These costs are likely to rise as pressure for environmental protection increases. As such, incorporating environmental cost directly into accounting systems and business strategies can enhance a firm’s competitive position (Gale & Stokoe, 2000).

A report compiled by White, et al (1995) for the U.S. Environmental Protection Agency revealed that environmental costs, often considered in the financial evaluation of a project, are those that are tangible and quantifiable, such as hazardous waste testing/monitoring, on-site wastewater pretreatment/treatment/disposal, and on-site hazardous waste pre-treatment/treatment/disposal. Alternatively, the environmental costs least frequently considered in project financial evaluation include environmental fines and penalties, corporate image, insurance costs, personal injury claims, marketable by-products, natural resource damage costs, legal staff time, and sales of environmentally-friendly/green products. These costs are generally perceived as less tangible, contingent, and difficult to quantify. The study also noted that in 70% of the firms surveyed, once the costs were quantified, they were included in financial assessments (White, et al, 2000).

From the perspective of internal and external costs, the less tangible expense tends to be the external cost, while the more tangible and quantifiable expenses represent the internal costs. The methods mentioned above for project appraisal are very much biased towards the inclusion of internal costs, as these represent the monetized cost to the financiers. Since external costs do not readily and directly affect the cash flow, they are less likely to be considered. Economists refer to these external costs as *externalities* as these costs are incurred by society as a whole but not factored into the cost-based value of the product. These external costs that firms impose on society must therefore be factored in profitability calculations and considered in the decision- making process. This process of integrating external costs with private or internal costs is referred to as *internalizing an externality*. Not only do these ensure the future viability of the firm through more comprehensive assessment of liabilities and risks, it also informs stakeholders of potential health and environmental costs from the organization’s economic activities (Gale and Stokoe, 2000).

Ethical Implications

Savitz (2006) explains that increasingly, businesses are expected to find ways to be part of the solution to the world’s environmental and social problems. To partially achieve this requires adopting techniques and policies that incorporate both internal and external costs. Some of these newer techniques would include Environmental Impact Assessments (EIAs), Life Cycle Assessments (LCAs), Full Cost Accounting and Environmental Cost/Benefit Analysis, and Triple Bottom Line (TBL) Accounting.



With this general demand for corporate sector involvement in socio-economic solutions, firms need leaders who embrace a values system of decision-making that enables them to assess all projects in relation to relevant stakeholders. In fact, this values system must become integral to the culture and moral fiber of the organization and uniformly applied across its operations. It also suggests that even board governance has to be approached in this manner to reinforce values-based leadership.

Conclusion

Becoming a sustainable enterprise requires a philosophical shift in the firm's methods of measuring success. Sustainability requires success to be measured in a holistic manner that gives due consideration to an organization's social, ethical, environmental, and economic responsibilities. Capital spending can determine a firm's value and future. Therefore, the methods used to assess capital projects are critical. It is imperative that firms make the ideological shift to becoming sustainable but to do so, values-based leadership is essential. Sustainable enterprises can only exist with this type of leadership and given the increasing competitive nature of today's economies together with intensifying uncertainties, companies that survive will inevitably be those that are operated by principled leaders.

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