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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

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AN EMPIRICAL INVESTIGATION OF CAPITAL BUDGETING PRACTICES IN INDIA

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ABSTRACT

Capital expenditure planning has assumed new dimension and has been given much attention both in finance literature and in practice. This is because capital expenditures involve committing huge sum of money, whose benefits extend well ahead into the future, and the future is related with risk and uncertainty, and, once committed, capital expenditure is irreversible. Thus, capital expenditure has huge impact on the future profitability and value creation of a company. The present study intends to focus on capital budgeting practices being followed by selected companies in India. The study being empirical in nature relies on primary data to achieve the objectives. The study found that the major firms in India are utilizing many of the tools of analysis presented in the financial theory for analyzing capital budgeting projects.

KEYWORDS
Capital budgeting, Capital rationing, Financial goals, Risk analysis.

INTRODUCTION
Capital investment is one of the areas that not only consumes a lot of resources in today's business, but demands the attention of all managers and sundry from inception of a project through growth stage to its maturity. However, in the finance literature, capital investments are often described as long-term investments. Long-term investments are difficult to deal with because risk and uncertainty must be accounted for, in addition to series of forecasting, implementation and monitoring of long- range decisions. Capital budgeting determines the shape and structure of a company and affects its competitive advantage. **Levary and Seitz (1990)** describe complex capital investment as a strategic decision with components and considerations of resource limitations and goal trade-offs.

In recent times, capital expenditure planning has assumed new dimension and has been given much attention both in finance literature and in practice. This is because capital expenditures involve committing huge sum of money, whose benefits extend well ahead into the future, and the future is said to be beclouded with risk and uncertainty, and, once committed, capital expenditure is irreversible. Thus, capital expenditure has huge impact on the future profitability and value creation of a company. **Farragher et al. (1999)** note that for a successful and effective capital expenditure planning, certain activities are necessary and shall be given attention. These are strategic analysis, establishing investment goals, searching for investment opportunities, forecasting cash flows of the investment, evaluating the risk of adjusted future cash flows, decision making, and implementing accepted opportunities and post audit procedures.

However, in the case of complex capital decisions there is the need for an objective analysis and evaluation of an investment together with a healthy intelligent judgment that has a solid base of knowledge about that investment, through the use of quantitative methods, such as mathematical programming (e.g., linear programming, goal programming and new financial techniques), as opposed to just a simple, sometimes subjective, judgment. Other wise the amount involved and all the efforts put in nursing the project will become what the accountants called sunk costs. Depending upon its magnitude the survival of the enterprise may be at stake.

Sound capital budgeting practices, among others, promote allocation of scarce resources and hence profitability of business. The process of capital budgeting decision making exists in every organization whether it is in public or private sector. Day in and Day out a significant portion of companies resources are being spent on different types of capital investments. There are several methods to evaluate capital investment decisions. Given the importance of capital investment, not only for the country as a whole, but also for the creation of shareholder wealth for individual firms, it may be helpful to investigate the practices used to evaluate these projects.

REVIEW OF LITERATURE
Over the past four decades, research in the area of corporate finance has examined various methods of capital budgeting preferred by industry. It has been noted that majority of the financial managers and academicians have not been in full agreement as regards the most appropriate capital budgeting method. The key findings of some of the existing studies are highlighted here.

INTERNATIONAL STUDIES
Prather et al. (2009) they surveyed members of the Durant, Oklahoma Chamber of Commerce to ascertain the level of sophistication that small rural businesses exhibit in capital expenditure decision making. This survey covered a variety of discounted cash flow (DCF) and other traditional techniques and also examined the incidence and treatment of capital rationing. Finally, they examined the methods used to determine the required return and the use of sensitivity analysis, scenario analysis, and simulation. Results reveal that 71%of the sample firms do not have a written business plan and 66% use managerial judgment in project selection.

Kantudu (2007) made an attempt to identify the most widely used techniques of appraising capital investment among quoted firms in Nigeria. He employed questionnaire method of primary data collection. The respondents were drawn from 200 finance and management staff of 100 quoted firms in Nigeria. The results revealed that firms favored a combination of investment appraisal techniques but the payback period is ranked highest among other techniques. He also found that simplicity, understandability and effectiveness to be the major preferential factors in the choice of a particular project appraisal technique. It is recommended that coordination, documentation, and communication of capital expenditure plans should be transparent and in line with the business interest of the firm.

Farragher et al. (2001) an attempt has been made to measure the relationship between capital budgeting sophistication and business performance. The results of the study do not support the hypothesis that companies with higher performance employ more sophisticated capital budgeting processes than do companies with lower performance. While they observe a negative sign for the degree of capital budgeting sophistication variable, the sophistication variable is statistically insignificant.

Graham and Harvey (1999) surveyed 392 CFOs about the cost of capital, capital budgeting, and capital structure. Large firms rely heavily on present value techniques and the capital asset pricing model, while small firms are relatively likely to use the payback criterion. Firms are concerned about maintaining financial flexibility and a good credit rating when issuing debt, and earnings per share dilution and recent stock price appreciation when issuing equity. They find some support for the pecking-order and trade-off capital structure hypothesis but little evidence that executives are concerned about asset substitution, asymmetric information, transactions costs, free cash flows, or personal taxes.

INDIAN STUDIES

Gupta et. al. (2007) carried out a research to explore which capital budgeting techniques are being used by industries in Punjab, and the influence of factors such as size of capital budget, age and nature of the company, and education and experience of the Chief Executive Officer. Towards this end, they conducted a primary survey. The survey reveals that the status of capital budgeting techniques in the state of Punjab is still far from satisfactory. Majority of the sample companies still use non-discounted cash flow techniques, mostly Payback Period criterion to evaluate any new project. Only a very few companies use DCF, and among them a very negligible number use NPV techniques to evaluate a project. Further, the study did not find any association between the size of capital budget, age of the company, nature of industry and capital budgeting techniques.

Anand (2002) surveyed 81 CFOs of India to find out about their corporate finance practices vis-à-vis capital budgeting decisions, cost of capital, capital structure, and dividend policy decisions. It analyses the responses by the firm characteristics like firm size, profitability, leverage, P/E ratio, CFO's education, and the sector. The analysis reveals that practitioners do use the basic corporate finance tools like NPV, CAPM and WACC. The study also reveals that the corporate finance practices vary with firm size.

Jain and Kumar (1998) found that companies were making regular investment for replacement and maintenance. One-fourth of the sample companies invested for expansion and diversification. The most preferred method was 'Pay Back period' followed by NPV and IRR. Preference for Pay Back Period method was due to its simplicity, less cost, less time, and easy understanding. For hurdle rate, WACC was preferred followed by 'Arbitrary rate' and 'Marginal cost of additional funds'. The companies, for incorporating risk preferred the 'Sensitivity Analysis' followed by 'Higher cut off rate' and 'Shorter Pay Back Period.

In a comprehensive study by Porwal (1976), it was found that ARR was preferred over IRR. Companies also preferred Payback Period due to the shortage of funds, obsolescence, and easy calculations. The most preferred rate of discount was WACC. The risk factors that were considered by the companies were 'chances of unavailability of inputs', probability of not achieving a target return' and 'uncertain market potential'. For incorporation of risk, 'Shorter payback Period' and 'Higher cut off rate' were preferred. Further, for rationing, 'Priorities' and 'higher rate of return' were the two main aspects for resolving conflicts among different departments.

Chandra (1975) selected 20 firms to examine the influence of size, industry group and capital intensity on the choice of investment evaluation techniques. The study revealed that 'Pay Back Period' method was mostly used for evaluating large size investments, the corporate preferred ARR. To evaluate investments, companies also looked at profit per rupee invested, cost saving per unit of product and investment required to replace a worker.

NEED OF THE STUDY

Capital investment decisions are the most important among the decisions involved in the functions of finance. More and more awareness is developing on the part of the companies about the need for using sophisticated methods for capital investment appraisal in place of traditional methods. As the magnitude and opportunities of investment are increasing it has become necessary for the companies to follow sophisticated capital budgeting methods rather than following rule of thumb methods which would lead to misleading decisions.

Recent times have seen a marked shift in favor of privatization, globalization, and free trade in many economies considered non-capitalist. India is no exception. More recent governments have shown a definite bias in favor of privatization and liberalized trade policies. A change from a policy of protectionism to a policy of free trade exposes Indian business to intense global competition. Businesses in India have to be more cost and quality conscious and allocate their scarce resources rationally, if they desire to meet the challenges of an increasingly competitive global market.

These kinds of situations are giving boost to conduct more and more research studies in this area. This study makes an attempt to find out the capital budgeting practices being followed by selected companies in India. Moreover, a brief perusal of review of literature reveals that vast number of studies in the area of capital investment decisions has been conducted in the global context but in India, there are a few numbers of studies in the area of capital budgeting (Prasanna Chandra- 1975, L S Porwal- 1976, Pandey-1989, Sahu-1989, Jain and Kumar-1998, Anand- 2002, Gupta et al.-2007). So, the existing literature on the subject brings home the fact that there is a need for conducting a study on capital budgeting practices in India.

STATEMENT OF THE PROBLEM

Looking at the gap in practice and in theory represented in the brief results of the previous studies and the theoretical assumptions, it is noticed that no agreed upon generalization can be made on the best technique to be used **(Chandra, 1975; Porwal, 1976; Deolanker, 1996; Vanhorne, 2002; Pandey, 2002; Arnold, 2008).** So, the perception of the advantages and disadvantages of each technique, and the type of the investment are important factors when selecting the technique to be used.

The researchers believe that each previous study is a special case and every new study tells something about capital budgeting practices at the time of conducting the study **(Pike, 1996).** So this leads to the fact that any new further study will bring a new insight into the use of the capital budgeting at the different time with different applications, keeping this into mind, the researcher made an attempt to study capital budgeting practices of selected companies in India.

RESEARCH OBJECTIVES

1. To identify the financial goals followed by the companies.
2. To determine which capital budgeting techniques are most commonly used by the selected companies.
3. To determine the methods used by the selected companies to consider risk in capital budgeting decisions.
4. To identify the major causes for capital rationing in India.

METHODOLOGY

The population chosen was a group of top 500 companies on the basis of market capitalization as published by Capital market. Owing to financial and time constraints, only the first 300 were selected as a sample. The information used in this study was obtained from questionnaires sent to the selected sample. Responses were encoded and the data was analyzed using the SPSS software. The study being empirical in nature relies on primary data to achieve the objectives. Primary data for the research will be collected with the help of self-administered questionnaire.

THE SAMPLE & CHARACTERISTICS

While data was collected from as many as 300 companies, there were only 125 companies in case of which the information is adequate to be included in analysis. Grouped into 9 industries, the sample had 25.6%of public sector and 74.4%of private sector companies.

A. SECTOR WISE BREAKUP OF THE COMPANIES IS AS GIVEN BELOW:

TABLE 1: OWNERSHIP OF THE FIRMS

Ownership	Frequency	Percent
Public	32	25.6
Private	93	74.4
Total	125	100.0

B. BREAK UP OF THE COMPANIES ACCORDING TO INDUSTRY CLASSIFICATION

TABLE 2: INDUSTRY PROFILE OF THE FIRMS

Industries	Frequency	Percent
Auto/Steel	20	16.0
Diversified/finance	20	16.0
Cement/Engineering/Construction	24	19.2
Telecom/IT	10	8.0
Oil/Gas/Food processing	13	10.4
Chemicals/Pharma	13	10.4
Power/Electrical	8	6.4
Trading/Misc	14	11.2
Textiles/Logistics	3	2.4
Total	125	100.0

SURVEY RESULTS & DISCUSSION

On the basis of review of empirical research and theoretical literature on finance, thirteen financial objectives were identified The respondent companies were asked to rate each objective on a five-point scale (most significant to insignificant) according to the relative significance attached to it. The weighted average score have been calculated.

TABLE 3: RELATIVE SIGNIFICANCE OF FINANCIAL GOALS

Goals	Most Significant	Moderately significant	Significant	Less Significant	Insignificant	Mean	St.dev
Maximizing							
Book Value of Net Worth	52 (41.6)	20 (16.0)	31 (24.8)	13 (10.4)	9 (7.2)	3.74	1.29
Market value per share	85 (68.0)	33 (26.4)	5 (4.0)	1 (0.4)	1 (0.4)	4.60	.68
Cash flow per share	30 (24.0)	17 (13.6)	52 (41.6)	21 (16.8)	5 (4.0)	3.36	1.13
Operating profit before interest and taxes	57 (45.6)	15 (12.0)	35 (28.0)	10 (8.0)	8 (6.4)	3.82	1.27
Price earning ratio	36 (28.8)	25 (20.0)	43 (34.4)	14 (11.2)	7 (5.6)	3.55	1.18
Market rate of return	6 (4.8)	25 (20.0)	58 (46.4)	12 (9.6)	24 (19.2)	2.81	1.10
Return on Investment	74 (59.2)	25 (20)	6 (4.8)	15 (12.0)	5 (4.0)	4.18	1.20
Net Profit to Net Worth	39 (31.2)	30 (24.0)	41 (32.8)	15 (12.0)	-	3.74	1.03
Net Profit margin	65 (52.0)	14 (11.2)	26 (20.8)	17 (13.6)	3 (2.4)	3.96	1.22
Market share	98 (78.4)	13 (10.4)	8 (6.4)	6 (4.8)	-	4.62	0.80
Earning per share	30 (24.0)	25 (20.0)	54 (43.2)	12 (9.6)	4 (3.2)	3.52	1.05
Total assets	30 (24.0)	30 (24.0)	45 (36.0)	14 (11.2)	6 (4.8)	3.51	1.11
Sales	71 (56.8)	16 (12.8)	17 (13.6)	18 (14.4)	3 (2.4)	4.07	1.22

Note: Figures in parentheses represent percentages.

Table 3 depicts the relative significance of financial goals as perceived by the respondent companies. It can be observed from the table that three top priority goals on the basis of mean and standard deviation. Maximizing market Share (WAS 4.62), Maximizing market value per share (WAS 4.60) and Maximizing return on investment (WAS 4.18) have been perceived as the main financial goals by the companies. However the financial goals of Maximizing market rate of return (WAS 2.81), Maximizing cash flow per share (WAS 3.36) and Maximizing total assets (WAS 3.51) have been perceived as the lowest preferred goals.

Table 4 reports findings on capital budgeting techniques most commonly used by the respondent companies, this shows that the discounted pay back period (92%) is most commonly used by the companies followed by Pay back period(82.4%), Internal rate of return (70.4%) and Net present value (66.4%).

In a survey by **Anand (2002),** 85% of the respondents considered IRR as a very important project choice criterion. About 65% of the respondents almost or always used NPV. The Payback method was also popular at 67.5%. In **Rao (1996)**'s study of 74 Indian companies, 51% favored IRR as the project appraisal technique.

TABLE 4: CAPITAL BUDGETING TECHNIQUES

Capital budgeting techniques	Frequency	Percent
Accounting rate of return	66	52.8
Pay back period	103	82.4
Post pay back profitability	2	1.6
Discounted pay back period	115	92
Net present value	83	66.4
Internal rate of return	88	70.4
Profitability Index	21	16.8
Terminal value	7	5.6
Real options	36	28.8
Adjusted present value	60	48
Modified internal rate of return	48	38.4

Table 5 represents the risk analysis methods used by the respondent companies to incorporate risk in capital budgeting decisions. In this case, there seems to be a high incidence of multiple responses. It can be observed from the table that maximum respondents favor sensitivity analysis technique (70.4%) for incorporating risk followed by shorter pay back period (69.6%) and break even analysis (48.8%) respectively.

TABLE 5: RISK ANALYSIS TECHNIQUES

	Frequency	Percent
Shorter Pay back period	87	69.6
Higher cut-off rate	14	11.2
Sensitivity analysis	88	70.4
CAPM	32	25.6
Scenario Analysis	85	68
Break-even analysis	61	48.8
Monte Carlo simulation	27	21.6
Decision tree	20	16
Certainty equivalent approach	7	5.6
Conservative Estimates of future cash flows	16	12.8

*Multiple responses have been given by some respondent companies

As Table 6 below illustrates the principal causes of capital rationing. Majority of respondents regard limit placed on borrowing by internal management (67.2%) as the major cause of capital rationing. But when the causes of borrowing limitations imposed by outside agreements (10.4%) or external management (5.6%) are added, the total of 83.2% suggest that capital rationing results from some type of debt limitation.

TABLE 6- CAUSES OF CAPITAL RATIONING

	Frequency	Percent
Debt limit imposed by outside agreement	13	10.4
Debt limit placed by external management	7	5.6
Limit placed on borrowing by internal management	84	67.2
Restrictive policy imposed upon RE for dividend payout	2	1.6
Maintenance of P/E ratio	19	15.2
Total	125	100.0

SUMMARY AND CONCLUSION

This paper has presented the findings of a survey of capital budgeting practices sent to a sample of 300 companies. Based upon the 125 usable responses received, the findings were analyzed on the basis of four major areas. The first section presented basic statistics describing respondent firms. The second section is on goal of the firms which disclosed that the major goal of the firm is to maximize market share followed by maximizing market value per share. The third section showed the capital budgeting techniques used by the firms for their investment decision making. It was found that most of the firms prefer discounted pay back period method as the important capital budgeting technique. The fourth section showed that most firms use sensitivity analysis followed by shorter pay back period method to adjust for risk. The final section found that the limit placed on borrowing by the internal management is the major cause of capital rationing.

In summary, it is evident that the major firms in India are utilizing many of the tools of analysis presented in the financial theory for analyzing capital budgeting projects. As indicated by the previous research that firms is continuing to move forward in the adoption of capital budgeting practices for their investment decision making.

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