

Capital Budgeting Procedures and Practices of Unsung Entrepreneur in Delhi

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Abstract: *This study investigated the extent to which capital budgeting practices and procedures are employed by unsung entrepreneurs of Delhi. Work in this area has been focusing on corporate firms, paying little attention to non-profit organizations. The study design adopted is the survey design. The study focuses on primary data as well as secondary data. Primary data were obtained from employees of individual firms using self-designed questionnaire, while secondary data were obtained from financial reports of the same firms. Data were analysed using computer software. The findings in this study indicate that the initial stages of capital budgeting process are being followed in firms, but minimal implementation follows. This is supported by: - proportion of participants who showed that they normally divert funds, presence of stalled and idle projects in firms and an indication that modern appraisal techniques of capital budgeting are not highly applied. A number of capital budgeting techniques find place in basic as well as advanced text books on Financial Management and Corporate Finance. Each technique has its pros and cons as a decision making tool. The research paper investigates the decision making practices of unsung entrepreneurs with respect to Capital Budgeting the techniques employed. The paper also examines the linkage between the techniques employed and various factors such as; size of investment outlay, nature of investment, firms size, and growth rate and capital structure. Also probed is the extent of delegation of decision making authority in respect of capital budgeting decisions. Further, the respondents' views on relative popularity/significance of the techniques and reasons for the same have also been studied. Furthermore, the differences in techniques and decision making practices of unsung entrepreneurs and popular companies operating in India have also been looked. The information/data for the above stated purpose was collected through a secondary data from some companies. The main findings extracted from the responses to the questionnaire are, that key decision makers of unsung entrepreneurs are quite aware of and practically using sophisticated capital budgeting techniques. The study shows that bigger size companies give greater preference to IRR, while unsung entrepreneurs rely more on NPV. Also unsung entrepreneurs are keener in estimating the payback period (PP) as compared to larger companies. Consciously or unconsciously the unsung entrepreneurs relying more on debt financing or with high growth rates give more preference to the NPV technique, while low leverage and low growth companies rely more on IRR. Unsung entrepreneurs account for big percentage of Indian jobs and yet most of the studies on capital budgeting techniques have been focused on large firms. A mistake in their capital budgeting process could lead to disastrous consequences as they do not have the financial clout to recover from them. The purpose of the paper is to investigate where small unsung entrepreneurs stand in regard to the use of capital budgeting techniques and risk analysis.*

Keywords: Capital budgeting, unsung entrepreneurs, Practices, procedures, Capital budgeting practices and procedures, large scale companies

1. Introduction

In Delhi unsung entrepreneurs, much concern has been given to physical facilities. According to the report by employees, the financial manager concern about an enormous backlog of expenditure on maintenance of unsung entrepreneur's buildings and other physical facilities, many of which have deteriorated badly. The importance of capital budgeting for an unsung entrepreneur cannot be overemphasized. Capital budgeting decisions have a long term impact on the viability of a firm and its ability to operate as a going concern. Compared to current asset management decisions, there is almost no room for flexibility or correcting a mistake if a wrong capital budgeting decision has been made and implemented. Given the importance of capital budgeting decisions, this research paper highlights commonly used capital budgeting techniques, computation of discount rate and methods for estimating project risk; as employed by unsung entrepreneurs and companies. In this regard, a survey questionnaire was designed to collect data from unsung entrepreneurs and companies.

One of the most important aspects of managing a company, besides leading it towards the vision of its owners, is the management of capital. The use of capital budgeting techniques is hence an integral tool in capital management.

Capital budgeting can be defined as the "total process of generating, evaluating, selecting and following up on capital expenditures". Hence, capital budgeting techniques would be the set of tools with which financial managers use to establish criteria for investing capital into available opportunities. A mistake in its capital budgeting process thus would cause a detrimental effect to the financial position of the company in the future. The pressure on a financial manager is understandably enormous. Therefore, depending on the needs and direction of the company, the financial manager is to apply capital budgeting techniques that would maximize the value of the company.

Furthermore, Peterson [1] states that, to correctly implement these techniques, analysis of the following is required:

- Its future cash flow;
- The degree of uncertainty associated with these future cash flows;
- The value of these future cash flows considering their uncertainty.

Even though small unsung entrepreneurs account for big percentage of all employment in India, limited studies have been done on small manufacturing companies. Hence, the aim of this research is to ascertain where small unsung entrepreneurs in India stand in regard to the use of capital budgeting techniques and risk analysis.

The design of the survey permitted us to thoroughly understand the financial decision taken by unsung entrepreneurs and companies making practices and their relationship with various characteristics of the firms. Specifically we mainly looked into the following:

- 1) Relationship between the size of the firm and the capital budgeting techniques used
- 2) Extent of delegation of authority in the firm in respect of capital budgeting decisions
- 3) Relative importance and significance of different capital budgeting techniques
- 4) Linkages of capital budgeting techniques used with the investment outlay.
- 5) Linkage of capital budgeting techniques employed with growth rate of firms
- 6) Basis for risk assessment of a project and for change in riskiness
- 7) Frequency of review of firm's cost of capital

Section II describes the sample selected for this paper and outlines the research methodology, Section III provides the findings and their impact for unsung entrepreneurs and companies in detail. Section IV presents conclusions and some recommendation. Most companies and unsung entrepreneurs follow academic theory and use discounted cash flow (DCF) techniques to evaluate investment projects.

2. Research Objective

The main objective of the study was to investigate capital budgeting procedures and practices of unsung entrepreneurs in Delhi. The following are the specific objectives of the study: -

- 1) to evaluate the status of the capital budgeting procures and practices of unsung entrepreneurs in Delhi.
- 2) To evaluate the extent to which employees are capable of following financial procedures
- 3) To find out the challenges that employees face when implementing these processes and practices
- 4) To identify possible solutions to solve these challenges

3. Empirical Literature Review

Capital Budgeting Techniques Used by Unsung Entrepreneurs and Large Organisation

The study showed that large organizations ranked Internal Rate of Return (IRR) first, followed by Net Present Value (NPV) and Pay Back Period (PBP) whereas unsung entrepreneurs ranked PBP first, Accounting Rate of Return (ARR) second and adjusted PBP and IRR third.

Surveys are few and far between when it comes to capital budgeting techniques and small manufacturing companies. In our survey, it was found that a large number of firms did not formally analyse all proposals. The results also showed that multiple evaluation techniques were preferred in the analysis of proposals. Techniques that were problematic in theory appealed to managers in practice. They concluded that their results of the capital budgeting survey were inconsistent with previous studies and they felt that it was due to the sample that they chose. Payback continued to be

the dominant technique employed not due to lack of sophistication but rather the financial pressures placed on them by financial institutions. In spite of this, small business has become more sophisticated and used DCF as the primary method of analysis as compared to earlier studies. However, this conclusion may be somewhat misleading as the discount rate was not scientifically calculated. Several surveys of capital budgeting practices reveal that the IRR is preferred over the NPV as an investment decision making tool in large scale companies. Practitioner's preference for the IRR is explained by the fact that IRR is treated as a display method and is more cognitively efficient. Since the IRR is expressed as an interest rate, it more closely resembles an analogy display, in which the IRR is simply compared to the required rate of return, whereas the NPV is expressed in rupees, resembling a precise digital display.

4. Methodology

Survey design was selected for the study. Survey design was appropriate for this study because it enabled the researcher to collect information concerning the current situation of unsung entrepreneurs as regards Capital Budgeting Procedures and practices. Primary data as well as secondary data were used. Primary data were obtained using a self-designed questionnaire from the employees of unsung entrepreneurs. The questionnaire focused on the capital budgeting process, evaluating how to it has been followed. The secondary data were got from financial reports of unsung entrepreneurs. Out of twenty unsung entrepreneurs firms, only fifteen of them responded. Data was analysed using computer software and presented in this paper. We designed a comprehensive survey questionnaire to collect the responses of the business firm.

The questionnaire was designed to probe into the seven main areas detailed in Section I. The responses were then tabulated for the purpose of analysis and drawing conclusions. A questionnaire was used to obtain information regarding the capital budgeting practices of the targeted unsung entrepreneurs. The survey, complete with reply paid postage, consisted of 12 close ended questions and 6 open ended questions. The survey sought to include small unsung entrepreneurs as well as a small proportion of medium sized companies. So the targeted companies were to have less than 100 workers under their employment

5. Results and Discussions

For the purpose of meeting research objectives the researcher felt a need to probe into the existing capital budgeting procedures and practices in the small scale firms.

5.1 Company Information

According to **Table 1**, majority of the manufacturing companies surveyed are in the small company category. It can be seen from **Table 2** that 13.34% of the respondents had a turnover of less than 12 lakhs. Next, 40% of the respondents had a turnover range between 12-20 lakhs. 26.66% of those surveyed had a turnover between 20-30 lakhs and only 6.66% of those surveyed had more than 40 lakhs in annual turnover. This data shows that even though

they are considered small manufacturing companies, they do have very large turnovers. Hence, they should at least be employing some sort of capital budgeting techniques that would properly manage their assets and capital to protect their future financial position.

From **Table 3**, it can be seen that majority of the respondents, 12% to be exact, were financial controllers of their respective companies. 12% of the respondents were managers, 13% were accountants with the rest being company secretaries, supervisors, directors and general managers.

Table 1: Number of employees

No. of Employees	Frequency	Percentage	Cumulative Percentage
1 - 29	4	26.67	26.67
30 - 59	5	33.33	60
60 - 89	3	20	80
90 - 119	2	13.34	93.34
>120	1	6.66	100
Total	15	100	100

Table 2: Annual turnover of respondents

Annual Turnover (in lakhs)	No. of Companies	Percentage
>12	2	13.34
12-20	6	40
20-30	4	26.66
30-40	2	13.34
<40	1	6.66
Total	15	100

Table-3 Position held by respondents

Position held	Percentage
Company secretary	8
Manager	12
Managing director	10
Accountant	13
Director	13
Financial controller	12
Supervisor	14
Assistants	18
Total	100

This data shows that even though these companies are defined to be small due to the fact that they have less than 100 employees, the principal decision making functions do not rest entirely on the shoulders of the owners or managers. Financial controllers and accountants have been employed to provide the owners with a better understanding of the consequences of their decisions in pursuing any particular project.

Respondents were asked to rank objectives of their company in terms of importance. The results are shown in **Table 4**. From the above table it is obvious that the most important objective of the companies is to make as much profit as possible. Furthermore, 66.1% of the companies felt that increasing profitability is the most important with a mean score of 4.55. Companies also felt that increasing sales growth, providing a high quality of service and the provision of their particular business were high on their agenda. One company stated that in order to be a successful company,

they needed to excel in all of the above objectives listed out. However, majority of the respondents felt that increasing employment did not have such a high priority on their list of objectives. This would probably be due to the fact that increasing employment would not necessarily aid in their aim on increasing profitability as it is widely known that labour costs are the highest contributing factor to the cost of production. As computers represent a lower cost in the long run, they are increasingly being used by manufacturers who only hire skilled labour to maintain these computers systems. Hence, the manufacturers do not view increasing employment as an important objective.

5.2 Financial Criteria

Respondents were asked about their use of capital budgeting techniques and the way with which they go about using it.

Table 4: Objectives of company

Objectives	Mean Score*
Increasing sales growth	4.27
Increasing profitability	4.55
Increasing employment	2.05
Provision of service	4.08
Quality of service	4.52

Table 5: Main areas where new investments were made in (respondents could choose more than 1 option)

Main Areas for New Investment	Percentage
Replacement and maintenance of machines	38
Extension of product lines	14
Expansion into new areas or markets	29
Safety of environmental concerns	12
Research and development	7

From **Table 5** above it is observed that 38% of the proposed investments go into the replacement and maintenance of machinery. Expansion into new areas or market is next on the agenda with 29% of respondents. Extension of products was next with 14% with the rest being safety of environmental concern and R & D.

Respondents were asked which techniques used when deciding which projects to pursue. The results are shown in **Table 6**.

It can be seen from **Table 6** that Payback period is the most heavily used method of evaluating projects with 48.4% of the respondents stating that they used the techniques most frequently. Only 4.8% of the respondents never used this technique. This would most probably have to do with it being one of the simplest techniques around that does not require expert knowledge in the field of finance. Having said that, unsung entrepreneurs may use this technique because they have obligations to their banks that do not always see the innovativeness of their ideas or look at the NPV or IRR of the investment but rather how soon they could repay the loans that they take out. They would use this technique to provide a gauge as to how fast they could get their money back from the investment. The arithmetic mean is 3.45 years which equates to a minimum payback period yield of 29% which is unusually high. This criterion would result in many investments being rejected as the medium return on

investment is not that high. From **Table 6** it can be observed that the Discounted Payback Period is not used frequently.

Only 12.9% of those surveyed used Profitability Index (PI) frequently, 33.9% never used this technique in the capital budgeting process. With a mean score of 2.39, it is not entirely favourable with financial managers but is still used once in a while. This technique could be used by them as a secondary tool to gauge a project. As PI is not entirely accurate when comparing between mutually exclusive projects, as the project may show the same increment in values but different net present values, this may explain the lack of usage. The mean score of 3.35 for the technique internal rate of return suggests that it is moderately used. It is also the next most popular technique after the Payback Period. This shows that the financial managers are using this technique along with NPV to compliment that of Payback Period. Even though it is not as commonly used as the Payback Period, it shows that small companies are beginning to adopt the usage of sophisticated capital budgeting techniques in their evaluation of investments. From **Table 6**, it shows that a whopping 43.6% of those surveyed have never used the technique Accounting Rate of Return while only 4.8% use it frequently. This shows that the technique is not popular among managers. This is because of the complexity of the techniques plus the fact that there are many variants and also that the techniques is flawed.

Table 6: Techniques used in project evaluation

<i>Techniques Used in Evaluating Projects</i>	<i>Never 1 (%)</i>	<i>2 (%)</i>	<i>3 (%)</i>	<i>4 (%)</i>	<i>Always 5 (%)</i>	<i>Mean Score</i>
Payback period	4.8	8.1	8.1	30.6	48.4	4.1
Discounted payback period	56.5	12.9	16.1	9.7	4.8	1.93
Net present value	14.5	11.3	27.6	20.9	25.7	3.32
Profitability index	33.9	29.1	14.5	9.6	12.9	2.39
Internal rate of return	14.5	12.9	22.5	22.5	27.6	3.35
Accounting rate of return	43.6	24.2	16.1	11.3	4.8	2.08

6. Summary

The researcher analysed the information gathered from the participants with the view of fulfilling the research objectives and answering research questions. The study revealed that in most small scale business, capital budgeting process is not a "one man show". This is supported by the percentage of respondents who outlined that the originators of investment proposals. Among the appraisal techniques, the study has indicated that intuitive management, which is highly nonmathematical, was highly applied than other techniques. Application of pay-back technique was second in preference. Little attention was being given to the modern appraisal techniques; in particular discounted cash flow. In search for schedule for fixed assets, the researcher was made aware that unsung entrepreneurs apply cash- basis of accounting, and hence not obliged to prepare annual balance sheets.

7. Conclusions and Recommendations

According to the findings, the following conclusion emerging from objectives of this study was made:-

The initial stages of capital budgeting process are being followed in small scale firms, but minimal implementation follows. This is supported by:- proportion of participants who showed that modern appraisal techniques of capital budgeting are not highly applied, which is seen from the proportion of participants using each of the techniques. The results indicate that even though the Payback period is still ever present in the evaluation of capital investments for small companies, it is encouraging to find that more sophisticated techniques like the NPV and IRR are being utilized to aid them in the capital budgeting process. It is recommended that small companies continue to focus on utilizing such sophisticated techniques that maximises the wealth of owners instead of succumbing to the financial pressure put on them by financial institutions.

Project evaluation is actually an integral part of the complete manufacturing strategy. Every investment or project should be followed up to determine that effectiveness of the decisions made in earlier stages of the capital budgeting process. It is further confirmed that project evaluation is not critical to those surveyed when a large number of them indicated that they did not perform post audits on capital investment. So it is recommended that more attention should be paid onto project evaluation as not every capital investment is properly analysed and small companies are more susceptible to these possible mistakes made as they do not have the financial muscle to recover. We suggested that government has to organise regular training programs on Capital Budgeting for new professionals entering the industry. This would augment the theoretical knowledge which the fresh graduates bring with them from Business Schools. Ultimately this will go a long way towards helping in optimizing the use of our resources and minimizing the chances of projects going sick due to incorrect or faulty capital budgeting decisions.

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