

CHAPTER - 3

Survey of Corporate Practice of Capital Budgeting

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Survey of Corporate Practice of Capital Budgeting**3.1: Introduction**

One important objective of this study is to examine the trend and process of capital budgeting practices in corporate houses in India. Therefore, conducting a survey of the corporate houses and gathering data in respect of industry practice of capital budgeting is the most vital part of this study. Mailed questionnaire methodology has been used for collecting information from the companies listed on National Stock Exchange, India. Data of 10 companies were received in the form of mailed questionnaire; responses twenty companies were collected using direct interview method using questionnaire. Data received from the responding companies have been compiled in this chapter. The responses have been obtained from companies spread across 14 different industries. The data so gathered from questionnaire responses are expected to give the ongoing industry practices followed by the corporate houses in India. Responses received from them have been presented in the different paragraphs below.

Table 3.1: Methodology of Survey

Number of companies Surveyed	Period of Survey	Method of Survey
30	2010 -2015	Mailed Questionnaire and Interview

3.2: Industry-wise Composition of the Sample Companies

The sample companies belong to various types of industries like Iron & Steel, Telecommunications, Information & Technology (IT), Airlines & Aviation, Metals, Power, Cement, Chemicals, Fertilizers, Petroleum and Pharmaceuticals. Industry-wise distribution of the sample companies has been presented in **Table-3.2**. As the study covers a reasonably good number of industries, it is expected that the findings and inferences to be drawn will represent true industry practice in terms of different aspects of capital budgeting decision-making in India.

Table-3.2: Industry-wise Classification of Sample

Industry	No of Companies	Percentage
Iron & Steel	05	16.67
Telecom	03	10.00
Airlines & Aviation	01	3.33
Metals	05	16.67
Power	04	13.33
Cement	04	13.33
Chemicals	01	3.33
Fertilizers	01	3.33
Petroleum	01	3.33
Pharmaceuticals	01	3.33
Sugar	01	3.33
Tea	01	3.33
Software	01	3.33
Diversified	01	3.33
Total	30	100.00

Source: *Survey Findings*

3.3: Distribution of Sample Companies on the basis of Ownership Structure

Ownership pattern of sample companies has been shown in Table 3.3. Out of 30 companies surveyed, 25 companies are public limited companies with majority private ownership. Only 5 companies belong to Public Sector, where Government's shareholding is substantial.

Table-3.3: Ownership Structure of Sample Companies

Nature of Ownership	No of Companies	Percentage
Private	25	83.33
Public	05	16.67
Total	30	100.00

Source: *Survey Findings*

3.4: Sector-wise Distribution of Sample Companies

Table-3.4, as presented below, highlights the sector-wise composition of responding companies. Out of 30 sample companies, 22 companies belong to manufacturing sector, six companies belong to service sector and remaining two companies belong to both the

sectors. It means that sample companies have been drawn from both the service and manufacturing sectors

Table-3.4: Distribution of Sample based on Nature of Companies

Nature of Company	No of Companies	Percentage
Manufacturing	22	73.33
Service	06	20.00
Both	02	6.67
Total	30	100.00

Source: *Survey Findings*

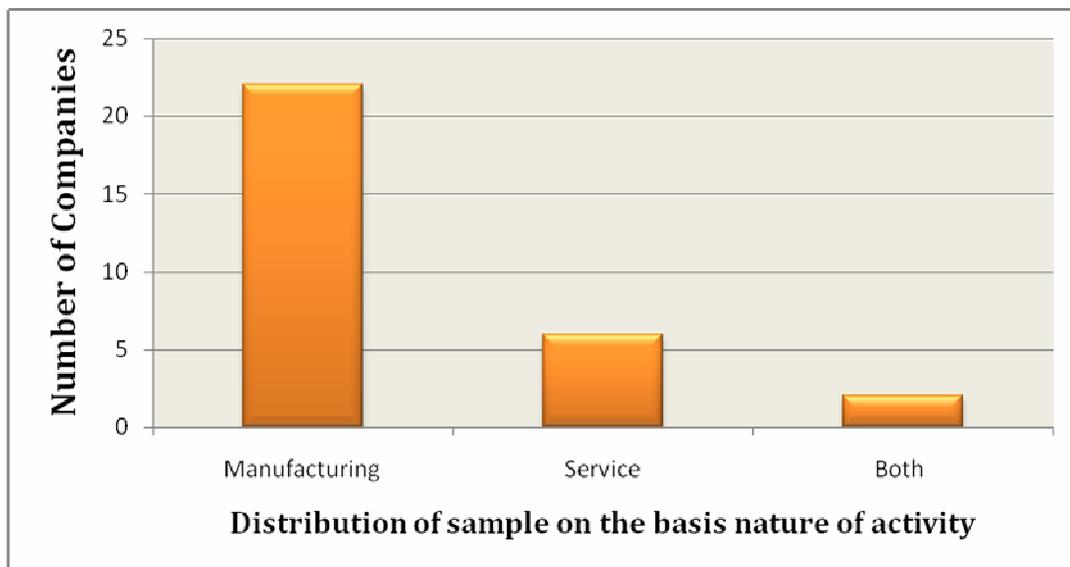


Fig.3.4: Distribution of sample on the basis of nature of activity

3.5: Size of Annual Capital Budget

Nine companies out of 30 companies surveyed abstained from providing any input regarding size of their annual capital budget. On the basis of responses received from 21 companies, size of average investment of each company has been determined. In order to have a clear picture about the size of capital outlay, a frequency distribution table has been prepared classifying the responses into four groups. The results have been summarized in the above **Table-3.5**. It is observed that around 43% of companies are having average annual capital budget between ₹1,000 and ₹5,000 crores. Out of 21 respondent companies five companies are having average annual capital budget of less

than ₹500 crores. 19% of sample companies invested more than ₹5,000 crores as average annual capital budget during the period of our study.

Table 3.5: Size of Average Annual Capital Budget

Annual Average Budget (Figures are in ₹ crores)	No of companies	Percentage
Less than 500	5	24%
501-1000	3	14%
1,001-5,000	9	43%
Above 5,000	4	19%
	21	100.00

Source: *Survey Findings*

3.6: Purpose of Capital Budgeting of Sample Companies

The purpose of making capital investment may be expansion, replacement, launching a new product and building infrastructure. Proposal for launching a new product, usually originates in the Marketing Department, where the Head of Marketing plays the key role. Proposal for replacement of existing equipment usually occurs from the production department or from the Operational Manager (Van Horne, James p.309). Some of the companies surveyed report that market expansion and proposal for launching a new product are vested with strategic planning division of their corporate houses.

Table – 3.6: Purpose of Capital Investment

Purpose	Frequency	Percentage
Market Expansion	25	83.33
Infrastructure	11	36.67
New Product	08	26.67
Replacement	01	3.33

Source: *Survey Findings*

From **Table-3.6** it is found that the maximum numbers of investments are made to pursue market expansion, which accounts for 83.33% of the total investments made. Expansion of the size of production and exploring new market segments are counted as market expansion. Market expansion is followed by infrastructure development. Capital Budgeting for launching a new product occupies third position with weights equal to 26.67%. Capital investment in replacement was reported in one case only. It seems that

companies are more interested in expansion and re-building than spending money on replacements. Industry-wise capital investment done for various purposes is presented in **Table-3.6A**

Table-3.6A: Industry-wise capital investment made for various purposes

<i>Industry/Purpose</i>	Expansion	New Product	Replacement	Infrastructure
Iron & Steel (5)	4	1	0	1
Telecom (3)	3	0	0	2
Airlines & Aviation(1)	1	0	0	0
Metals(5)	4	2	0	2
Power(4)	3	0	0	2
Cement (4)	3	0	0	2
Chemicals (1)	1	0	0	1
Fertilizers(1)	1	1	0	0
Petroleum(1)	1	1	0	0
Pharmaceuticals (1)	1	1	1	0
Sugar(1)	1	0	0	0
Tea(1)	1	0	0	0
Software(1)	0	1	0	1
Diversified (1)	1	1	0	0
Total (30)	25	08	01	11

Source: Survey Findings

The distribution of the purpose of capital expenditure has been shown in Fig. 3.6A

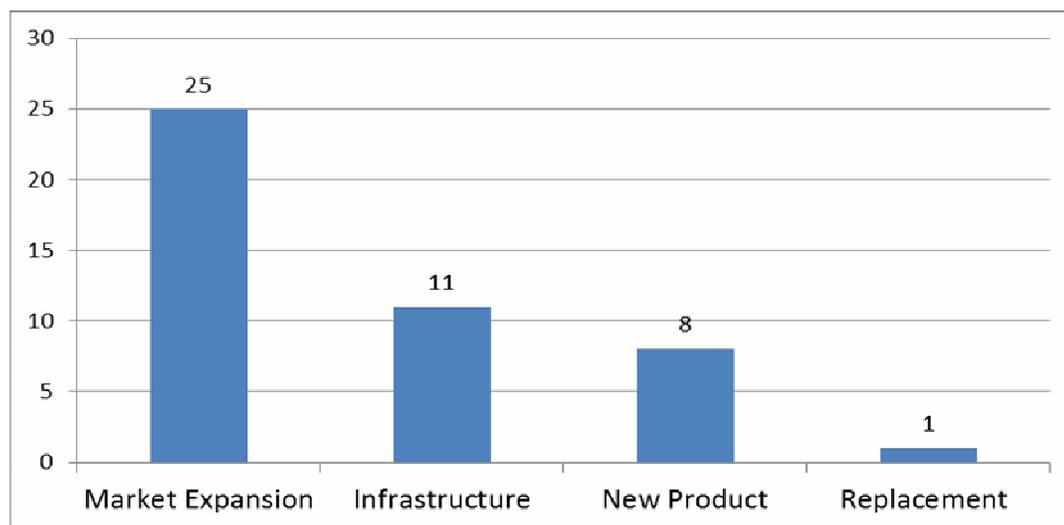


Fig. 3.6A: Purpose of Capital Investment in sample companies

3.7: Organization Structure, Decision-making Authority and Capital Budgeting

Project identification, screening, financial evaluation and project review are the different stages in capital budgeting. In this study it has been tried to examine the actual process of capital budgeting decision making and the role of people in the organization. These aspects have already been studied by many researchers in the field of corporate finance, viz., Bower Joseph (1970), Kersyte Agne (2011). They observed that companies, in general, follow top-down approach in capital budgeting decisions. In most of the companies proposals of new projects were initiated by Strategic or Corporate Planning Group and finally approved by CEOs or Board of Directors. Capital investment projects were approved finally by top management. In case of replacements, proposals were conceived by Divisional Heads or Unit Heads and subsequently forwarded to the top level for approval.

The study attempts to examine whether there is any major change in organizational practice. The findings *in present study are in consonance with the above research studies*. Questions were asked about the origin, decision and implementation of capital investment decision making. So far as the origin of capital investment decision is concerned, it is observed that majority of the decisions were originated at board level, which stands at 66.67% of responding companies. In 26.67% of companies proposals were initiated by the Head of the Division, Strategy Department & Managing Director (Table-3.7).

Table 3.7: Capital Investment Decision initiating authority

Capital Investment Decision initiating authority	No. of Companies	Percentage
Board	20	66.67
Finance Executive	3	10.00
R & D Department	2	6.67
Workers	0	0
Head of the Division	8	26.67
Head of Marketing	1	3.33
Consultant	0	0
Strategic Planning Department	8	26.67

Source: Survey Findings

Finance Executives, Research & Development Dept. and Head of Marketing also play an important role in initiating capital investment as substantiated in Table-3.7 reveals the dominance of top level management in presenting proposal for implementation of their capital projects. Out of 30 respondent companies, two-thirds mention that capital investment proposals originated at the board level.

3.8: Initiating Authority of Capital Budgeting Proposal

In the questionnaire, one question was earmarked for obtaining information regarding the authority who initiates the capital investment suggestion. Out of 30 respondent companies, investment suggestions were initiated by Divisional Heads in case of 83.33% of companies, by Strategy Department & Managing Director in 6.67%, by Managing Directors only in 10% and the rest 10% by Operating Managers. Thus in most of the cases investment suggestions were originated by the Divisional Heads.

Table- 3 .8: Capital Investment suggestion initiating authority

Capital Investment suggestion initiating authority	No. of Companies	Percentage
Worker	0	0
Operations Manager	2	6.67
Divisional Head	25	83.33
Strategy Dept. & MD	2	6.67
MD	3	100.00

Source: Survey Findings

3.9: Final Investment Decision-making authority

The final investment decision-making authority may be vested with the CFO, Board of Directors, Chairman or Managing Directors. In this study it is observed that the final decision making power for capital investments rests with the top management as reflected in **Table 3.9**. Out of 30 companies responded to the question, in 27 companies the final investment decision is entrusted to the Board of Directors (BOD) , Chief Managing Director (CMD), Chief Executive Officer (CEO) and Chief Financial Officer(

CFO) of companies. Only in few cases the authority for taking final decisions given to Divisional Head and Project Head.

Table 3.9: Final Investment Decision-making authority

Final Investment Decision-making authority	No. of Companies	Percentage
Board of Directors ,CMD,CEO,CFO	27	90.00
Divisional Head	2	6.67
Project Head	1	3.33
Total	30	100.00

Source: Survey Findings

3.10: Key role playing authority in capital investment decision

Out of 30 responding companies, Boards of Directors play a key role in 26 companies. It accounts for in 86.67% of companies. Managing Directors also plays a very crucial role in 56.67% of sample companies. It is also found that Finance Executives are also engaged in playing key role in 10% of the sample companies. (Table-3.10)

Table 3.10: Key role playing authority in capital investment decision

Key role playing authority	No. of Companies	Percentage
Board of Directors	26	86.67
Managing Directors	17	56.67
Finance Executives	03	10.00
Others (CEO, Regional Project Managers etc)	02	6.67

Source: Survey Findings

Note: The percentages do not add up to 100% due to multiple responses

3.11: Project Appraisal and the Role of Funding Authority

Out of 30 companies surveyed 24 companies are reported to depend on loan financing, either alone or in combination with internal funding. Two companies tapped only loan financing for financing their projects. Submitting Project Report is one of the requirements of for resorting to loan financing. Twenty-five companies responded that

funding authority ask for project appraisal report at the time of sanctioning funds. In case of companies where the financing of capital is done through retained earnings, submission of project appraisal report may not so strongly required. However, the top level management would require the justification of project proposals through evaluation of expected benefits from the proposed projects.

Table-3.11: Project Appraisal Report requirement by funding authority

Response	No. of Companies	Percentage
Yes	25	83.33
No	0	0
NA	5	16.67
Total	30	100.00

Source: Survey Findings

3.12: Size of Outlay and Influence on Investment Decisions

An effort was made in the questionnaire that whether executives are influenced in investment decision making by the size of outlay. Mixed responses have been received on this issue. From 30 companies responded, 17 companies were of the opinion that the size of capital outlay influences in investment decision. Only five companies say that size of capital expenditure have no role in investment decision. Executives of 27% of companies responded that this question is not applicable to their companies.

Table-3.12 Size of outlay and influence on investment decisions

Response	No. of Companies	Percentage
Yes	17	56.67
No	5	16.67
NA	8	26.66
Total	30	100.00

Source: Survey Findings

3.13: Magnificent feeling job in capital investment projects**Table- 3.13: Choice of feeling wonderful in investment projects**

Sl. No.	Objective/priority	Yes	No/No response*	Total
1	Accepting project with big capacity	12	18	30
2	Project with high potential profit	18	12	30
3	Project with low payback period	6	24	30

Source: *Survey Findings*

**Five companies ignored this question totally*

3.14: Priority assigned to objectives

Table-3.14 given below summarizes the preferences assigned by responding firms to various objectives as per their own perception. Respondents were asked to document their observations on a five point scale, viz. highest priority, high priority, moderate priority, low priority and no priority. It is observed that almost all the four objectives mentioned in the table is assigned equivalent weightage. However, the objective of 'acquiring biggest market share' is assigned by 26 companies (16+10) with highest and high priority which is the maximum among all the objectives. The two most important objectives are 'acquiring biggest market share' and 'to see that sales is growing fast'. Other objectives seem to be comparatively slight less important. It is found that to see the rise in share prices in the market is the least important objective in the opinion of the respondents. However, the former objectives may lead to the latter goals.

Table-3.14: Priority assigned to objectives

Sl. No.	Objective/priority	1	2	3	4	5	Total
1	To show that sales is growing fast	0	4	1	11	14	30
2	Acquiring biggest market share	1	1	2	10	16	30
3	To ensure regular payment of return	1	0	6	13	10	30
4	To see rise in share price in the market	1	2	5	13	9	30

Source: *Survey Findings*

3.15: Grounds on which investment requests rejected at Board level

The questionnaire includes a point about the grounds on which investment requests were rejected at Board level. The grounds of rejection are classified as economic, non-economic, strategic and technical. A majority of companies keep them silent on the issue and did not give any response. However, only few companies reveal their position about the grounds of rejection. Out of 30 sample companies, in case of two companies investment requested were rejected on economic reasons and in four companies investment requests were rejected at Board level on non-economic and strategic grounds. In none of the respondent companies the same was rejected due to technical reasons. Therefore, it can be concluded that corporate strategy and non-economic factors plays a dominant role in capital investment decision making.

Table- 3.15: Ground of rejection of investment request

Ground of rejection/ No of companies	Yes	Not responded	Not applicable	Total
Economic	2	27	1	30
Non-economic	4	25	1	30
Strategic	4	25	1	30
Technical	0	29	1	30

Source: *Survey Findings*

3.16: Conclusion

Corporate houses spend considerable volume of resources on capital budgeting. Nearly fifty percent of the companies surveyed spend Rs 500 crore to Rs 1000 crore per annum. The long-term investments are considerable done to facilitate expansion programme of the corporate houses. As the economy is growing, it unfolds greater prospect for the corporate houses to increase market share and raise the volume of sales. Capital Budgeting has a big role to play. The ultimate authority of taking decision of capital budgeting is extensively vested with the directors and managing director. The authority of decision-making and analytical aspects of capital budgeting gradually getting transferred to strategic corporate division from conventional chamber of CFOs.