Volume : 4 | Issue : 10 | Special Issue Oct- 2015 • ISSN No 2277 - 8179

CAPITAL BUDGETING PROCESS: THE ORETICAL ASPECTS

Management

KEYWORDS:

Upasana Sheoran

Department of commerce & Management, Rajiv Gandhi Govt. College for Women, Bhiwani

ABSTRACT

Today's business environment is highly competitive and it has made the capital investment decision as key issue for business entities. Now it is important for business organisations to make efforts to understand appropriate capital budgeting techniques from ample range of techniques as in form of basic text books of corporate finance, financial management and advanced capital budgeting. Capital investment is important in creating the shareholder wealth for an organisation. It is essential to examine the practices adopted in evaluation of the projects. Corporate capital investment studies are lacking by remaining indifferent for project evaluation and risk analysis during the entire investment decision making process.

Capital budgeting is the method of assessing, matching and deciding upon capital projects where the best return can be gained through investment upon time. It lays stress on the capital expenditures where the specific analysis is done to select upon which capital expenditure needs to be made. Due to its nature of long-term investment, it is one of the most significant factors to act as pillars of success

Introduction

In global economy there are the conditions of balanced increase in the assortment and range of competitive connections; uncertainties and risk involvement and that have become hindrance in the investment decisions of a firm. Refined capital investment process must be there for effective allocation that may increase the possibility of making appropriate investments by ensuring that corporate strategy will be followed, all investment opportunities will be well thought out properly time and again, and that unfavourable political part of informal decision making will be minimized.

Capital investment decisions is the most critical type in order of managerial decisions required in a company as it is having implications in long-term whether positive or negative, to improve corporate performance and for a success of a company managers need to understand capital investment decisions.

Capital investment decision depends on decision rule applied under prevailing circumstances and the decision rule itself considers three factors such as cash flows, project life and discounting factor. Effectiveness of investment decision depends upon efficient assessment of these factors. Cash flows depend upon the immense understanding of micro and micro environment of the economy. Assessment of project life is must as it may change the entire perspective of the project. Cost of capital is considered as discounting factor which has faced many changes over the years. Hence evaluating the investment will have an immense impact by estimating the fair cost of capital. This research paper focuses upon the investment process, techniques and criteria for evaluating capital budgeting projects and how it can help in risk minimization and wealth maximization of shareholders.

Basic Assumptions in Capital Budgeting

All cash flows are considered while determining the true profitability of the project.

- Accounting profits does not affects the decisions
- Timing of cash flows is vital
- Cash flows integrate opportunity costs. Incremental cash flows are used that are total of cash flows arise as a result of taking on a particular project.
- Bigger cash flows are always preferred than the smaller ones and similarly instead of late cash flows; the early ones are more preferred.
- Cash flows are on after-tax basis-taxes should be incorporated in the analysis.
- The weighted average cost of capital is use to discount the cash flows and as of it financial costs are ignored in the cash flows

Corporate Strategy, Capital Budgeting Process and Performances Capital projects are associated with goals and the strategic planning of a business. Martinsburg in his operational or functional strategy, (Neil, 2008) acknowledge the attractiveness of investment proposal comes from different sectors of the business. For making fine investment decisions managers of a company need to understand their firm's competitive advantage. A strategically positioned firm generate the most value of its assets and determines the growth opportunities of a firm. Avoidance of corporate strategy in decision making process while make the whole process unrealistic even if the project evaluation techniques, cash flow forecast and screening and other capital budgeting process has been done well.

Capital budgeting is considered as a part of finance that has fascinated many academicians, many theories literature on it since Shapiro's pioneering work in 1968 has been developed. Capital budgeting decisions and theories have various stages or activities which are termed as capital budgeting process. This process includes project search, corporate strategy, goals and objectives, cash flow estimation evaluation techniques monitoring and controlling of options (Brealey et al 2008). Each activity of this process has impact on capital budgeting decision which twists the performance of the firm. With passing of decades, theoretical get through have lead the way to more complex techniques and theories that firms uses in capital budgeting practices(Ecole 2006). In the literature of capital budgeting a lot of significant progress has been made to bridge the gap between theory and practice ranging from the project idea to monitoring and controlling of cash flows.

Significance of Capital Budgeting for Growing and Distressed businesses

Capital budgeting is important for every firm as the success and failure of any business depends upon how available funds are utilized. The significance of capital budgeting do not lies only in the techniques used, such as NPV and IRR, but is lying in the varying key involved in forecasting cash flow. Capital expenditure can be considerable and drastically impact the financial performance of the firm. Proper investment appraisal process is essential as investments need time to mature and capital assets are long-standing, it will effects the firm in long term.

However, the significance of capital budgeting decisions differs for a growing and distressed business. The need for working capital and cash flows varies for growing and distressed firms. A firm is considered growing when it generates sufficient cash flows and grow at a significant rate than the overall economy. When a firm is growing, it usually keeps more of the profits as retained earnings instead of distributing the profits as dividends.

Following reasons will show the importance of capital budgeting for growing firm:

- Capital budgeting techniques assist the management in saving itself from excess investment, because a growing firm takes benefit by having right to use the funds. If the investments are extreme it may root higher expenses and depreciation.
- Capital budgeting decisions increase the firm's capacity and strength to face the competition as growing businesses face tough competition.
- Capital budgeting techniques help the growing firms in selecting the proposals having the objective of shareholders wealth maximization.
- Appropriate analysis of capital budgeting is required for the booming of a firm because investment decisions results in higher stock prices and enhance cash flows.

Financially distressed businesses have different conditions. When a firm is not able to pay or have difficulty in paying off its debts is called distressed. The possibility of financial distress increases if a firm has high fixed costs, has illiquid assets and revenues which are hypersensitive to economic plunges. Capital budgeting is important for distressed firm because of the following reasons:

- Capital rationing gives scope for financial manager to analyse various business only feasible projects must be taken up, this makes capital rationing as a most important feature for a distressed firm.
- Distressed firm bears difficulty in raising funds that will create a danger of under investment as of it firm may lose its market share in comparison of its rival firm. Capital budgeting helps the organisation to avoid under investment.
- Capital budgeting restrains the over expenditure incurred on the projects.

Capital budgeting process: situation analysis

Investment decision making should be efficient as it is required for corporate survival and long term success. It helps in developing competitive advantage of a firm by influencing its profitability, its processes, its technology and its working practices. There are a number of characteristics which are important for a capital budgeting decision to be valuable, which may include:

It is dynamic in state, not static. It clearly shows that the quality of information can be improved over time, for it integration of sequential and multiple decision process information is required to get cash flow estimates into the financial analysis of the cash flow.

In relation to the company's multiple stakeholders, it is connected by strategy implementation. There relevant non financial data and forecasts supports the project proposals.

It recognizes the intrinsic options in value-enhancing capital budgeting.

It takes a cross-functional approach. The estimates of expected cash flows and the uncertain cash flows are critical in quality. Many functions within the company provide the underlying information for these estimates and those providing information as strategic partners in the process.

- It treats the company's compensation system as a focus of capital budgeting. As there is always a possibility for poor decisions so the rewards is aligned with how capital is allocated.

It gives due importance to performance-based training. Those using capital budgeting across the entire company must understand it, buy it and implement it consistently. Cross-functional training intended to increase the performance of those who are involved in it.

The process of decision making creates the related features of capital budgeting, like procedural rationality and politics, where procedural rationality is gathering relevant information by working on its analysis and concluding to a choice and then implementing that choice as a decision. Political aspect of decision making has two main ideas. First, people in organizations different interests as of hierarchal, functional, professional and personal factors. Second, individuals start focusing on self interests and try to influence the outcomes of decisions by using various political techniques for it.

It has been recommended that political behaviour and procedural rationality are two balances of a scale recounting a single dimension of decision making and provides challenging explanations for decision making behaviour, empirically shown that they are two separate dimensions.

The literature of investment management shows two main approaches defining the capital budgeting can be differentiated: the normative approach and the process approach.

The normative approach shows the traditional theory on capital budgeting tells about the criteria on which the investment decision depends of an enterprise. As per this approach the stress is on financial evolution, choice of the long term-investment in assets, improved capital budgeting techniques and their request for many situations are main problems.

For sophisticated capital budgeting process, rigorous evaluation techniques are important components, the success of investment decision depends on improving the entire process. The capital budgeting process is looked upon as in its whole and the company's decision support system needs informational support for effective decisions.

Conclusion:

In this chapter, many techniques of capital budgeting under the assumption of certainty as well as uncertainty have been discussed, highlighting their relative strengths and weaknesses.

The process approach has wider perception then normative approach and tries to describe the complete process by which the project proposals are being identified, developed, justified and lastly approved. Most of the models describes the capital budgeting processes are generally depended upon the case studies, and the related literature as a result it is strongly acquainted with experiments. Management has tried to determine how firms can improve their investment processes and why it is so hard to differentiate between normative views and descriptive statements.

Capital bugdeting process explains a complex variant stage process in these stages managers at several levels of a company play different role. Economic and technical process is derived by lower level mangers which helped in directing project definition. Project impetus is given by middle managers via socio- political process. Objectives, preferences organisational structure and systems are derived by senior division for strategic and structural contexts for investment decisions.

However, creation of new organisational capabilities is different from the process of investing in strategic projects. There is direct involvement of senior managers in defining various stages of the projects and there is indirect involvement in setting strategic and structural contexts. The findings of the paper support the plan that investment decision making is a decision-level and not a firm level construct.

REFERENCE

1. Adams, C., Bourne, M., Neely A. (2004). Measuring and improving the capital planning process. Measuring Business Excellence, Vol. 8, No. 2, 23-30. | 2. Adler, R.W. (2000). Strategic Investment Decision Appraisal Techniques: The Old and the New. Business Horizons, November-December, 15-22. | 3. Adler, R.W. (2000). Strategic Investment Decision Appraisal Techniques: The Old and the New. Business Horizons, November-December, 15-22. | 4. Amit, R, Schoemaker, P.J.H. (1993). Strategic assets and organizational rent. Strategic Management Journal, Vol.14, 33–46. | 5. Angelou, G.N., Economides, A.A. (2009). A compound real option and AHP methodology for evaluating ICT business alternatives. Telematics & Informatics, Vol. 26, Issue 4, 353-374. | 6. Boquist, J.A., Milbourn, T.T., Thakor, A.V. (1998). How Do You Win the Capital Allocation Game? Sloan Management Review, Vol. 39, Issue 2, 59-71. | 7. Burns, R.M., Walker, J. (2009). Capital Budgeting Surveys: The Future is Now. Journal of Applied Finance, Vol. 19, Issue 1/2, 78-90. | 8. Dean, Jr., Sharfman, M.P. (1993). Procedural rationality in the strategic decision making process. Journal of Management Studies, Vol. 30, 607-630. | 9. Dean, Jr., Sharfman, M.P. (1996). Does decision process matter? A study of strategic decision-making effectiveness. Academy of Management Journal, Vol. 39, Issue 2, 368-396. | 10. Ducai, M.T. (2009). Aspects regarding the capital budgeting. Review of Management & Economic Engineering, Vol. 8, Issue 1, 173-182. | 11. Eisenhardt, K. M., Zbaracki, M. J. (1992). Strategic decision making. Strategic Management Journal, Vol.13, 17-37. | 12. Farragher, E.J., Kleiman, R.T., Sahu, A.P. (1999). Current Capital Investment Practices. Engineering Economist, Vol. 44, Issue 2, 137-150. | 13. Helfat, C.E. (1997). Know-how and asset complementarity and dynamic capability accumulation: the case of R&D. Strategic Management Journal, Vol.18, 339–360. | 14. Helfat, C.E., Peteraf, M.A. (2003). The dynamic resource-based view: Capability lifecycles. Strategic Management Journal, Vol. 24, Issue 10, 997-1010. | 15. Koch, B.S., Mayper, A.G., Wilner, N.A. (2009). The interaction of accountability and post-completion audits on capital budgeting decisions. Academy of Accounting & Financial Studies Journal, Vol. 13, 1-26. | 16. Maccarrone, P. (1996). Organizing the capital budgeting process in large firms. Management Decision, Vol. 34 Issue 6, 43-56. | 17. Madhani, Pankaj, M. (2008). RO-Based Capital Budgeting: A Dynamic Approach in New Economy. ICFAI Journal of Applied Finance, Vol. 14, Issue 11, 48-67. | 18. Maritan, C.A. (2001). Capital investment as investing in organizational capabilities: An empirically grounded process model. Academy of Management Journal, Vol. 44, Issue 3, 513-531. | 19. Maritan, C.A., Coen, C.A. (2004). An agent-based model of investing in capabilities: processes, decisions and performance. Academy of Management Proceedings, N1-N6. | 20. Maritan, C.A., Coen, C.A. (2011). Investing in Capabilities: The Dynamics of Resource Allocation. Organization Science, Vol. 22, Issue 1, 99-117.