CAPITAL BUDGETING PRACTICES IN NEPALESE MANUFACTURING COMPANIES

A dissertation proposal submitted to the Office of the Dean, Faculty of Management
in partial fulfilment of the requirements for the Master's Degree

By

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December, 2019

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CHAPTER-1

INTRODUCTION

1.1 Background of the Study.

Capital budgeting is a process of planning capital expenditure which is to be made to maximize the long-term profitability of the organization. Capital budgeting is a long-term planning exercise in selection of the projects which generates returns over a number of years in future and the heavy expenditure is to be incurred in the initial years of the project to generate returns over the life of the project. The term capital budgeting refers to planning for capital assets. The capital budgeting decision means a decision as to whether or not money should be invested in long-term projects such as installing a machinery or creating additional capacities to manufacture a part which at present may be purchased from outside. It includes a financial analysis of various proposals regarding capital expenditure. The Finance Manager has various tools and techniques by means of which he assists the management in taking a proper capital investment decision.

Sound capital investment decisions are critical to the survival and long-term success of firms, and therefore, they are considered as a strategically important decision for overall growth of the firm and its financial health.

Leon et al. (2008) finance theory stipulates the use of Discounted Cash Flow (DCF) techniques, which come in the form of the Net Present Value (NPV) and the Internal Rate of Return (IRR), as the most appropriate criteria in evaluating capital investments. In addition, Hendricks (1983) and; Garham and Harvey (2001) provided the evidence that another competing non-DCF based technique exists, such as the Payback Period; it is also widely used by companies. Kester et al. (1999) found that the payback period for investment decision was still an important method. The question that begs investigation is whether or not companies do actually use the “correct” techniques to evaluate capital projects including risk. Survey evidence suggests a widespread use of DCF methods.

Capital budgeting decisions in manufacturing firms is the decision to invest in long-term assets like acquisition of new assets and equipment, replacements of machinery,

investing in development under research and expansion of existing facilities are helpful in improving the smoothness of the production systems and deliver high quality products. On the other hand, expansion decisions are aimed to utilize the existing opportunities in the market and lead the firm to the growth.

Various researches have been conducted in capital budgeting practices in developed countries .Senior manager of the large corporations in the United States have broadly studied regarding their companies investment decisions, especially during the 70s and 80s. Among the several researches are those reported by Christy (1966), Mao (1970), Klammer(1972), Fregren(1973), Petty,Scott and Bird (1975),Gitman and Forrester (1977),Pattillo (1977), Schall, Sundem and Geijsbeek(1978), Kim and Farragher (1981), Hendricks (1983), Klammmer and Walkar(1984) and Pike and Sharp(1989).
Christy (1966) found that sophisticated capital budgeting methods were being used or seriously considered by a small number of firms mostly large in industries with high investment rates and speedy changes. Most of the remaining firms were believing on methods which were simpler and theoretically less satisfactory. Mao (1970) identified an extensive difference between the theory and practice of capital budgeting among the US firms in that period. It was characterized by the increased uses of such analytical techniques as mathematical programming. Utility analysis, probability and Statistical theory. The practice of capital budgeting had but business executives did not appear to have adopted many of the new techniques. Klammer (1972) studied on the empirical evidence of the adoption of sophisticated Capital budgeting techniques by large manufacturing firms of US in 1970.

These studies showed that there is increasing trend in the uses of sophisticated techniques to make the investment decisions. Theses researches which have focused on methods of evaluating projects profitability and risk have revealed that the sophisticated of the analytical techniques used by US executives has increased over the year .They have identified a number of techniques, which are Net Present Value (NPV), Internal Rate of Return (IRR), Profitability index (PI), Accounting Rate of Return (ARR) and Discounted Payback Period (DPBK).

The Studies after 90s are dedicated to revealing the current trend in the uses of capital expenditure decision making techniques. Some of them are Bierman (1993), Trahan and Gitman (1995), Jog and Srivastava (1995), Arnold and Hatzopoulos (2000), Hall

(2005) and Holmen and Pramborg (2006). They have identified the four most commonly quoted methods of capital expenditure evaluation techniques used by US, European and Canadian Firms which are Payback Period (PBK), Accounting Rate of Return (ARR), Net Present Value (NPV) and Internal Rate of Return (IRR).

Net Present Value (NPV), Internal Rate of Return (IRR) have become dominant method of evaluating and ranking capital investment proposals in Asia-Pacific region .However the capital investment decisions making practices in this region are much less rigorous than that in the US and Europe.

1.2 Problem Statement and Research Questions

For the research questions, following are some of the questions that will be taken under consideration.

i. Whether or not Nepalese manufacturing companies are practicing Capital Budgeting tools?
ii. Which of the capital budgeting tools are mainly practiced and which aren't practiced till now?
iii. What are the major difficulties in the application of Capital Budgeting tools?

1.3 Objective of the Study

In order to accomplish my research objective, this study seeks to address the following research objectives.

i. To examine the present practice of capital budgeting tools in the manufacturing companies of Nepal.
ii. To examine and determine the capital budgeting tools practiced in Nepalese manufacturing companies.
iii. To explore the prevailing difficulties in applying capital budgeting tools in Nepalese manufacturing companies.

1.4 Rationale of Study

This study examines the extent to which capital budgeting techniques are utilized in manufacturing firms to determine the profitability and the variables that lie therein. The

study will be beneficial in terms of getting the idea about the current scenario of factors affecting the capital budgeting practice in Nepal. It would be helpful:

i. It examines the application of capital budgeting tools in manufacturing companies of Nepal.
ii. It explores the problems and potentialities of the selected companies. It will be useful to the potential investors, lenders, managers and policy makers.
iii. It provides information on the application of the tools under different circumstances. Thus, it will encourage the use of capital budgeting tools in decision making to those companies who have yet used any tools.
iv. Last but not the least, it provides literature to the researcher who wants to carry on further research in this field.

1.5 Limitation of the Study

Before making concluding comments, it is important to note several limitations of this study as follows.

i. The study is concerned with capital budgeting. It does not consider the economic aspects of the companies.
ii. The study is focused on the selected manufacturing companies. Thus, the findings might not be applicable to other companies of Nepal.
iii. The research is based on primary data only. No secondary data has been used for this present study.
iv. This study pays attention to the practices of capital budgeting only. It does not consider the implementation aspects of the tools.

The data were collected through questionnaire. The information is based as perceived by the finance executive of respective manufacturing companies. In this context the actual practices and the perceived practices might be different

CHAPTER-2
REVIEW OF LITERATURE

The second section will be crucial. Here the researcher will review works by different previous researcher in order to attain an understanding on the degree of available information that the researcher will base on to attain value for the study.

Kengatharan (2016) conducted his study on the topic "Capital Budgeting Theory and Practice: A Review and Agenda for Future Research". The main objective of this study was to explain the capital budgeting theories and practices in different countries and demonstrate the disparities between theories and practices of capital budgeting. It is crucial to answer the research questions in order to attain research aims. The first question enquired about "what are the capital budgeting theories and practices used by firms? Are there any disparities between the capital budgeting theories and practices? If so, how?" The answers for these questions have been well documented during the last twenty years of studies. Capital budgeting theory recommends in using DCF methods (NPV, IRR, MIRR, and DPB) and non DFC methods (PB and ARR) for making capital budgeting decision. However, all most all the firms in developed and developing countries inclined to use sophisticated capital budgeting methods along with many capital budgeting tools for incorporating risk (i.e., sensitivity analysis, real options) and sophisticated discounted rate (i.e., WACC, CD, CAPM). Thus it can be concluded that there are some disparities between capital budgeting theory and practice. The next research's question further backs up to this question.

The second question asked about "what are the factors determines the use of capital budgeting practices? Are there different across countries? If so how?" Numerous factors have been identified as the determinant of capital budgeting during the last two decades including size of the firm, ownership structure, nature of industries, educational qualification of CFOs, experience of CFOs, age of CFOs, uncertainty (for example, interest rate, inflation, foreign exchange rate), nonfinancial consideration and other factors (i.e., economic, human, technology, finance, ethical and political). Among them, some factors (for example, size of the firm, educational qualification of CFOs, experience of CFOs, and age of CFOs) were positively associated with the use of sophisticated capital budgeting practices.

Etal. (2006) conducted a study where he compared the use of capital budgeting methods and their effect on performance of organizations in China and Netherlands. In his study he had received a total of 87 organizations, 42 enterprises were from Netherlands while the rest were from China. Therefore, the results indicated that 22 Chief Executive Officers of Chinese companies applied or used Net present value methods unlike only 4 CEO used the traditional way of investment decisions techniques.

Gupta & Pradhan (2017) conducted a research about capital budgeting decisions in India. They study was applied to manufacturing and non-manufacturing companies. A sample of 250 companies was given a questionnaire and only 75 of them responded. Their results indicated that the discounted techniques are used most of these companies when the social benefits and accounting are applied when evaluating the rate of return of the project. The result shows that there is a similar kind of approach adopted by both manufacturing and non-manufacturing sectors for capital budgeting decisions in India.

Louderback and Hirsch (1982), replacement decisions involve an investigation of new methods of production compared to existing machinery and technology. Managers of firms can choose to retain current equipment (status quo) or they can opt for new equipment.

Chasteen, Flaherty and O' Connor (1998), replacement decisions occur when the firm purchases new equipment that has virtually the same operating capabilities as it predecessor.

Warren, Reeve and Fess (2002) cost of acquiring fixed assets includes all amounts spent to get it in place and ready for use.

Speciland, Sepe and Tomassini (2004, P. 464), described costs to get expenses in the required form and condition and locations suitable for the usage.

Edwards (2008) argued that alternatives for acquiring machinery include lease and purchase plan. The leases are similar to the operating lease though an operator of the machine can take a decision fundamental and provide avenues for the execution of an aspect to the lease upon the return.

Stein (2016) investment appraisal techniques are methods used when investing in longterm projects such buying machinery, building or conducting research and development. Some of these methods consider the value of money in the future.

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CHAPTER-3

RESEARCH DESIGN AND METHODOLOGY

3.1. Research Design

A survey research design is defined as the systematic gathering of information from respondents for the purpose of understanding and/or predicting some aspect of the behavior of the population of interest. This research lies into descriptive survey research.

The study will entirely be cross sectional and will use a quantitative research design in the data collection process. The data will be collected from a sample of 10 manufacturing companies. The data will be collected by forming and coming up with a set of questionnaires which will be distributed among the respondents.

The study would be based on the statistical test such as mean, standard deviation etc. Statistical Package for Social Science (SPSS), Microsoft Excel and E-views will be used to analyze and interpret the data collected.

3.2. Population and Sample

Population refers to the complete set of elements (persons or objects) that possess some common characteristic defined by the sampling criteria established by the researcher. The population for the study comprises of all manufacturing entities of Nepal.

A sample is a smaller representative of the entire population in a study. When conducting surveys, the sample is the members of the population who are invited to participate in the survey. Hence said, a sample is a subgroup or subset within the population. As the population will be too large to be studied, hence the small and carefully chosen sample of respondent will be used to represent the population.

3.3. Sources of Data

The data will be collected from the primary sources. So, qualitative and quantitative data would be taken for the study of the research. Primary data will be acquired through questionnaire survey.

3.4. Data Collection and Processing Procedure.

Along with the secondary data, questionnaire will be the main tool to be used in this research to collect data. The study of descriptive research with involvement of survey method that has to be used. Primary data will be collected through questionnaire to obtain quantitative data. Personal survey method to be used as observation and in personal method, researcher interviews the respondent by providing the questionnaire. The relevant data will be presented in meaningful tables, figures, graphs and charts. It will help to find out the conclusion from the available data.

3.5. Data Analysis Tools and Techniques.

After the completion of the data collection the information that will classified, edited, coded, categorized and properly recorded in the SPSS, Microsoft Excel and E-views. Data will be processed in a manner so that they will be accurate and consistent with the research objective.

For the analysis of the data several statistical tools such as SPSS, Microsoft Excel, etc. will be used to analyze and interpret the data. For the presentation of data, several tools like table, diagrams, pie-charts, histograms, etc. will be used. Moreover, tools like mean, median, mode, standard deviation, quartiles, frequency distribution, etc. will be used.

CHAPTER PLAN

Chapter 1: Introduction

The chapter introduction would give the synopsis of the study. This chapter states the problem objectives, introduction of the subject explanations why the problem should be solved and who will be interested in the solutions.

Chapter 2: Review of Literature

This chapter deals with reviews of previous writing, studies, which are relevant to the problem being explored within the conceptual framework. It also presents the summary of previous major researches being studied under separate heads as well as explains the reason for choosing the respective literature for the critical review and how it assisted in building the conceptual framework identifying the problem statement needed for the study.

Chapter 3: Research Design and Methodology

This chapter discusses about the various methods and techniques applied for conducting the research. It basically discusses about what research design was used for research, what methods were used to carry out the data collection from respondents, processing, analysis, methodology used for the study.

Chapter4: Result and Discussion

This chapter discusses about the findings, analysis used to process data collected for research. It also identifies the degree of relationship between various variables identified as independent and dependent for the study.

Chapter 5: Summary and Conclusion

Finally, this chapter summarizes the whole research finding and forwards the appropriate recommendations on the basis of the research. The summary of the findings reiterates the measures that are developed, explored from the research, data gathered and analyzed. It presents the data findings in a logical, rational manner to the problem area and research hypothesis within the conceptual framework.

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