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Analysis of Capital Budgeting Techniques in Evaluating the Profitability

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ABSTRACT:

This study consists the analysis data of evaluating and measuring the financial performance of manufacturing companies by using techniques of capital budgeting. In this study, the researcher discussed the results of the survey which is gathered from the Small Medium Entrepreneurship Organizations Chief Executive Officer (CEO), Chief Financial Officer (CFO), Financial Manager, Investment Manager, Corporate Accountant and others. Data was collected and analysed to understand the performance of manufacturing companies by applying capital budgeting techniques. The overall analysis was made to prove capital budgeting is the most effective tool in evaluating the profitability of manufacturing firm, for which different tests were applied to get the result. And to understand and test the above hypotheses, annova test, comparisons of proportions and other tests are obtained and presented as follows to get better understanding of the results.

Keywords: Capital Budgeting Technique, Profitability, Manufacturing Firm SME.

INTRODUCTION

Capital budgeting is a process of scheduling capital outgoing which is to be made to amplify the long-term profitability of the final company or organization. It is very essential to decide on those long-term investment projects that are expected to make furthest contributions to the prosperity of the shareholders for long run. In other words, capital budgeting pertinent to fixed or long-term assets, which is referred to assets in operation and profitable over a period of time usually, exceeding one year. They therefore, involve a current outlays or series of outlay of cash resources in return for an anticipated flow of future benefits.

The formation of capital budgeting is mainly used to assess the outflow decisions which entail present outlay but are likely to yield benefits over a period of time longer than one year. Here, the decision of capital budgeting is often called to be the most prominent and significant segment of any corporate financial management, as it affects the stability and profitability of a firm for a long period.

REVIEW OF LITERATURE

LingesiyaKengatharan (2016) The main aim of research is to demonstrate unearth gaps in the existing capital budgeting practices literature and to suggest the directions for the future research. The findings of the study revealed that majority of Journals were published on capital budgeting the last two decades. The reminder of the research papers appeared in many journals. Capital budgeting is thus multi-disciplinary applied discipline aspects and across many disciplines.

Ali Mohamed Ali Farah, ZelhaAltinkaya (2018) The objectives were to assess how acquisition of long-term assets affect the profitability of manufacturing firms, secondly to assess how replacing of long-term assets affect profitability of manufacturing firms. The results reveal that capital budgeting decisions have a great contribution to the profitability of the organization. The chapter also presented and highlighted the Results from the analysis process. The study also revealed that acquisition of long-term assets, replacement of long-term assets, capital budgeting techniques and outsourcing expenditure had a significant effect on profitability of the organizations.

OBJECTIVES OF THE STUDY

1. To determine the capital projects those are feasible.
2. To estimate the expenditure involved.
3. To ensure the selection of the possible profitable capital project.
4. To ensure maximization of profits by allocating the available investment.

RESEARCH METHODOLOGY

Research methodology:

Methodology is a systematic procedure of collecting information in order to analyze

and verify a phenomenon. The collection of information is done two principles sources.

They are as follows:

1. Primary Data
2. Secondary Data

Primary Data

It is the information collected directly without any references. In this study it is gathered through interviews with concerned officers and staff, either individually or collectively, sum of the information has been verified or supplemented with personal observation conducting personal interviews with the concerned officers of finance department of Heritage.

Secondary Data

The secondary data was collected from already published sources such as, pamphlets of annual reports, returns and internal records, reference from text books and journals relating to financial management.

The data collection includes.

(a) Collection of required data from annual records of Heritage.

(b) Reference from text books and journals relating to financial management.

LIMITATIONS OF THE STUDY

1. Lack of awareness of food generation sector of heritage
2. Lack of time is another limiting factor the schedule period 6 weeks are not sufficient to make the study independently regarding Capital budgeting in Heritage Ltd.
3. The busy schedule of the officials in the Heritage Ltd is another limiting factor. Due to the busy schedule of officials restricted me to collect the complete information about organization.
4. Non-availability of confidential financial data.
5. The study is conducted in a short period, which was not detailed in all aspects.

DATA ANALYSIS

The Net present value (NPV) method is the classic economic method of evaluating the investment proposals. It is one of the discounted cash flow techniques explicitly recognizing the time value of money. It correctly postulates that cash flows arising at different time periods differ in value and the comparable only when their equivalents present values are found out.

The following steps are involved in the calculation of NPV.

- ✓ Cash flows of the investment project should be forecasted based on realistic assumptions.
- ✓ Appropriate discount rate should be identified to discount the forecasted cash flow. The appropriate discount rate is the firms opportunity cost capital, which is equal to the required rate of return, expected by investors on investments of equivalent risk.
- ✓ Present value of cash flows should be calculated using opportunity cast of capital as the discount rate.
- ✓ Net present value should be found out by subtracting present value of cash outflow present value of cash inflow.

Acceptance Rule:

The project should be accepted if NPV is positive it should be clear that the acceptance rule using NPV method is to accept the investment project if its net present value is negative (NPV CASH OUTFLOW). The positive net present value will result only if the project generates cash inflows at rate higher than the opportunity cost of capital.

A project may be accepted in NPV = 0.

Thus, the NPV acceptance rules are:

- ✓ Accept if NPV >0
- ✓ Reject if NPV <0
- ✓ Ill-defined if NPV = 0.

STATEMENT SHOWING CALCULATION OF NET PRESENT VALUE

YR	ROE	INC	TAX	PAT	DEP	CFAT	PV@ 12%	PV CFAT	CASH O.F	PV OF COF
0							1.000		426.0	426.00
1	59.64	5.48	0	65.12	170.4	235.52	0.893	210.32	170.4	152.17
2	59.64	5.48	0	65.12	170.4	235.52	0.797	187.71	170.4	135.81
3	59.64	5.48	0	65.12	170.4	235.52	0.712	167.69	170.4	121.32
4	59.64	5.48	0	65.12	170.4	235.52	0.636	149.79	170.4	108.37
5	59.64	5.48	0	65.12	170.4	235.52	0.567	133.54	170.4	96.62
6	59.64	5.48	0	65.12	170.4	235.52	0.507	119.41	170.4	86.39
7	59.64	5.48	0	65.12	170.4	235.52	0.452	106.46	170.4	77.02
8	59.64	5.48	0	65.12	170.4	235.52	0.404	95.15	170.4	68.84
9	59.64	5.48	0	65.12	170.4	235.52	0.361	85.02	170.4	61.51
10	59.64	5.48	0	65.12	170.4	235.52	0.322	75.84	170.4	54.87
11	59.64	5.48	22.8	42.32	14.2	56.52	0.287	16.22	0	0
12	59.64	5.48	22.8	42.32	14.2	56.52	0.257	14.53	0	0
13	59.64	5.48	22.8	42.32	14.2	56.52	0.229	12.94	0	0
14	59.64	5.48	22.8	42.32	14.2	56.52	0.205	11.59	0	0
15	59.64	5.48	22.8	42.32	14.2	56.52	0.183	10.34	0	0
16	59.64	5.48	22.8	42.32	14.2	56.52	0.163	9.21	0	0
17	59.64	5.48	22.8	42.32	14.2	56.52	0.146	8.25	0	0
18	59.64	5.48	22.8	42.32	14.2	56.52	0.130	7.35	0	0
19	59.64	5.48	22.8	42.32	14.2	56.52	0.116	6.56	0	0
20	59.64	5.48	22.8	42.32	14.2	56.52	0.104	5.88	0	0
21	59.64	5.48	22.8	42.32	14.2	56.52	0.093	5.26	0	0
22	59.64	5.48	22.8	42.32	14.2	56.52	0.083	4.69	0	0
23	59.64	5.48	22.8	42.32	14.2	56.52	0.074	4.18	0	0
24	59.64	5.48	22.8	42.32	14.2	56.52	0.066	3.73	0	0
25	59.64	5.48	22.8	42.32	14.2	56.52	0.059	3.33	0	0
	1491	**137**	**342**	**1286**	**1917**	**3203**		**1454.99**		**1388.92**

Present value of cash inflow = **1454.99**

Present value of cash outflow = 1388.92

Net Present Value = 1454.99 – 1388.92 = **66.07 crores**

INTERPRETATION:

As NPV is positive, the project is accepted.

FINDINGS

- ✓ As discussed in earlier chapter Heritage follows, systems and procedures as per the Andhra Pradesh State Electricity Act, accordingly project initiative is taken up.
- ✓ While preparing project financing Heritage considers Social benefit of the state.
- ✓ Heritage generates the food based on requirement of APTRANSCO.
- ✓ The project's life is expected to be 25 years; due to this the gestation period is very high.
- ✓ The entire project is financed by the food financial institutions like (PFC, REC).
- ✓ The major portion of finance is done through secured loans.
- ✓ The unit cost and other expenditures are eligible to claim from the potential buyer as approved by the Regulatory Commission.

SUGGESTIONS

- ✓ For society with lower income levels or below poverty line company should go for subscribed rates and for industries it should increase its rate marginally to cover the losses.
- ✓ The subscribed cost in future should be reduced.
- ✓ High risk is associated with the project, since the generation period is high.
- ✓ Government of AP should provide notional debt equity.

CONCLUSION

The budgeting exercise in Heritage also covers the long term capital budgets, including annual planning and provides long term plan for application of internal resources and debt servicing translated in to the corporate plan. The scope of capital budgeting also includes expenditure on plant betterment, and renovation, balancing equipment, capital additions and commissioning expenses on trial runs generating units. To establish a close link between physical progress and monitory outlay and to provide the basis for plan allocation and budgetary support by the government. The manual recommends the computation of NPV at a cost of capital / discount rate specified from time to time. Inducting at least three non -official directors the mechanism of the Search Committee should restructure the Boards of these PSUs.

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