Impact of Project Size and Social Cost Benefit Analysis on Capital Budgeting Decisions of Indian Firms

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Abstract

Purpose : This paper is an exploratory research on the application of capital budgeting techniques in Indian companies. Two parameters - project size and social cost benefit analysis were considered for the study and the influence of these factors for the adoption of capital budgeting techniques by the Indian companies has been analyzed.

Design/Methodology : This paper is based on the primary data. OLS (observed least square model) was used to evaluate the degree of relationship between project size and social cost benefit analysis with the frequency of usage of capital budgeting techniques in the companies and with the type of capital budgeting techniques used by the companies.

Findings : Using a sample size of 75 companies, the result shows that there is a positive relationship between frequency of usage of capital budgeting techniques and application of discounted cash flow techniques with the firm project size and social cost benefit analysis.

Practical Implications : The paper provides information to the students and researchers about the practices adopted in the Indian companies related to capital budgeting techniques.

Originality/Value : The paper provides new insights about the frequency of the capital budgeting techniques used in the firms along with the type of technique used by the companies.

Keywords : **capital budgeting, DCF techniques, project size, social cost benefit analysis, regression analysis**

JEL Classification: G31

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Capital Budgeting decisions are of paramount importance to the organization and every company adopts a different technique for different capital investment decisions. Capital budgeting is a process of evaluating long-term capital investment decisions of the company. It is a budget for major capital or investment expenditures. It is one of the most important decisions taken by a finance manager. Apap and Masson (2004) defined capital budgeting as a process of analyzing projects and deciding whether they should be included in the capital budget or not. According to Chandra (2004), capital expenditures have three distinctive features - they have long term consequences, they often involve substantial outlays, and it may be difficult or expensive to reverse the decision. Gitman and Forrestor (1977) defined capital budgeting as those decisions which help to change the future firm's opportunities. Thus, capital budgeting decisions decide the future of the firm and favorable investments can yield magnificent returns. On the other hand, an ill-advised and erroneous decision can endanger the survival of the firms.

Capital budgeting techniques are of two types: Non discounted cash flow techniques (traditional techniques) and discounting cash flow techniques. In discounted cash flow methods, projects are evaluated on time money of value basis, and in the non-discount method of capital budgeting, time value of money is not considered.

Many of the limitations of non discounted techniques are taken care by discounted cash flow techniques. Schall and Sundem (1980) supported the above statement that more sophisticated capital budgeting techniques provide superior decisions for corporates. There are various factors which affect the capital budgeting decisions like size of the firm, size of the project, type of industry, type of the company, and so forth. This paper not only discusses about the types of techniques used by the companies, but also discusses the frequency of techniques used by the companies according to the size of the project and use of social cost benefit analysis.

The present paper discusses the impact of two variables - project size (PS) and social cost benefit analysis (SCBA) on the type of capital budgeting techniques (TOT) and frequency of capital budgeting techniques (FOT) used by the Indian firms. In this paper, two independent variables have been considered - project size and adoption of social cost

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benefit analysis by the companies and two dependent variables, type of techniques (whether discounted or non discounted capital budgeting techniques) and frequency of techniques (total number of techniques used for evaluation of a project). Primary data, which was collected from various companies from different States, has been used for the present paper. In addition, observed least square model was used to test the impact of the predicting variables such as size of the project and effect of social cost benefit analysis for evaluating the capital investment projects by the companies.

Review of Literature

The capital budgeting process helps a business to determine whether projects such as building a new plant or investing in a long-term venture are worth pursuing. Oftentimes, a prospective project's lifetime cash inflows and outflows are assessed in order to determine whether the project is profitable or not. Popular methods of capital budgeting include net present value (NPV), internal rate of return (IRR), discounted payback period, profitability index under discounted cash flow (DCF) techniques and payback period, and accounting rate of return (ARR) under non discounted cash flow techniques.

According to Klammer (1972) and Oblak and Helm Jr. (1980), most of the U.S. MNCs are using DCF techniques for evaluation of capital projects ; this finding is in contrast to the findings of Pinches and Lander (1997). According to them, in developing countries like India, for multinationals, the calculation of cash flows is one of the main issues because of which DCF techniques are less used. Danielson and Scott (2006) found that small firms' decisions are more compulsive than discretionary. In India, companies are using both discounted and non discounted techniques, but the usage varies from company to company. The type of technique used is not only based on the size of the firm; in fact, few large companies also apply techniques according to the size of the project. According to Andrews and Butler (1986), Ross (1986), and Ryan, P. and Ryan, G. (2002), the size of the capital budget is a significant factor in the choice of capital budgeting methodology. It depends on the size of the project - which type of capital budgeting techniques will be applied by the company and also frequency of techniques used by the companies for better evaluation of the project. Ryan, P. and Ryan, G. (2002) have analyzed the positive relationship between sizes of the budget with the use of discounted capital budgeting techniques.

Pollock (2002) said that the social cost-benefit analysis refers to cases where the project has a broad impact across society and, as such, is usually carried out by the government. Social cost-benefit analysis is concerned with the theory and application of criteria for investment decision making in the public sector. Whereas, in the private sector, appraisal of investments, financial analysis of private costs and benefits takes place against wealth-maximizing objectives function, and cost-benefit analysis focuses on social costs and benefits (including externalities and costs and benefits to third parties). This gives cost-benefit analysis a wider social or economic character with the objectives of maximizing the wealth of a country as a whole.

The objective of the present study is to find out the relationship between applications of social cost benefit analysis with the use of capital budgeting techniques. After conducting a survey for the present paper, it was found that most of the companies were using SCBA while evaluating a project, and this also affects the decision relating to the project.

Hypotheses

The following were the hypotheses formulated through literature review.

- **H01 : Firms with large project size do not use more number of capital budgeting techniques for evaluating a project.**
- **H1: Firms with large project size use more number of capital budgeting techniques for evaluating a project.**

- **H02: Firms with large project size do not use discounted cash flow techniques for evaluating capital investment projects.**
- **H2: Firms with large project size use discounted cash flow techniques for evaluating capital investment projects.**

- **H03: Firms adopting social cost benefit analysis do not use more number of capital budgeting techniques.**
- **H3 : Firms adopting social cost benefit analysis use more number of capital budgeting techniques.**

- **H04: Firms applying social cost benefit analysis do not use discounted cash flow techniques for evaluation of capital investment projects.**
- **H4 : Firms applying social cost benefit analysis use discounted cash flow techniques for evaluation of capital investment projects**

Methodology

- **Study Type :** The study is based on exploratory research and hypotheses testing. According to **Collis and Hussey (2003)**, exploratory research is performed when there are few or no earlier studies to which we can consign the information about the issue or the research problem. The objective of this type is to look for patterns or testing the hypotheses. The present paper is more about getting to know the parameters influencing companies for applying the various capital budgeting techniques. Regression analysis was also used to find the causal relationship between dependent and independent variables.

- **Sample :** The present research is based on primary data. The data was collected with the help of a structured questionnaire from different companies across industries. Data were collected from both public sector and private sector companies using questionnaires. The time period of the study is from January 2011 to January 2012.

- **Sample Size :** The study surveyed a cross section of public sector and private sector firms. In all, questionnaires were sent out to 250 companies through various means, and the firms responded to the survey with a response rate of 30%. Hence, this paper is based on the results of 75 companies (see Annexure 1), who responded with duly filled questionnaires. The survey was designed to know about the corporate practices related to capital budgeting decisions.

- **Sampling Method :** The questionnaire was sent to companies of all sizes - small, medium, and large sized companies . The random sampling approach was used for the present study, where questionnaires were sent to companies on a random basis. The details of the companies were obtained through the databases of various banks as well as companies. Most of the questionnaires were sent to the sample companies directly, and some questionnaires were sent to the firms through banks. Banks were selected on the basis of convenience.

- **Statistical Tools Used for Analysis of Data :** The questionnaire intended to explore various constructs based on literature review. Both the factors PS (project size) and SCBA (social cost benefit analysis) were regressed with the dependent variables FOT (frequency of techniques) and TOT (type of technique) using OLS regression. On the basis of literature review, the determinants affecting the use of capital budgeting techniques were identified. The explanatory independent variables include project size and adoption of social cost benefit analysis by the company. The dependent variables are FOT (frequency of techniques) and TOT (type of technique), where the type of techniques are divided into two categories: one is discounted techniques and the second is non discounted techniques. Both were taken in different coding systems. TOT was converted into binary coding, where '0' was used for the companies using non discounted techniques, and '1' was used for the companies using discounted techniques. FOT coding was done on a scale of 1 to 5, according to the number of techniques applied by the company to evaluate the project. If a company applied one technique, then the code for the same will be "1", and if the company used two techniques, the code will be "2" and so on. The Table 1 explains the variables, PS and SCBA and also shows the impact of these independent variables on the both the dependent variables FOT and TOT (the note below the Table 1 shows the description of the PS coding).

Data Source and Sample Selection : Primary data were used for the present study. A survey of different companies was conducted. Out of the total sample of 75 companies, 45 are from the manufacturing sector, 20 are from service sector, and the remaining 10 are from different sectors like oil, mining, and engineering sectors as discussed in the Table 2. The Table 3 analyses the companies on the basis of project size. The Table 3 explains the minimum project size of the firm for application of capital budgeting techniques. Majority of the companies were going in for a formal analysis of the project if the project size was more than ₹ 1 crore. Very few companies kept a high limit for formal analysis of the projects. Only 10% of the companies were going in for formal analysis if the project size was more than ₹ 500 crore.

Table 1: Definition of Variables and their Impact on Different Parameters of Capital Budgeting Techniques

Variables	Description	Expected Impact on Frequency of Capital Budgeting Techniques used by the companies (FOT)	Expected Impact on type of Capital Budgeting Techniques used by the companies (TOT)
PS (Project Size) *	This is the total project size of the company, which is categorized into five sub categories.	Positive	Positive
SCBA (Social Cost Benefit Analysis)	Social cost-benefitt analysis refers to cases where the project has a broad impact across society.	Positive	Positive

Source: Author's Research

* The PS coding is done on a 5- scale basis from 0-4, where "0" is for more than ₹ 50 lakhs, "1" is for more than ₹ 1 Crore, "2" is for more than ₹ 10 Crore, "3" is for more than ₹ 100 Crore, and "4" is for more than ₹ 500 Crore

Table 2: Description of the Sample

Type of Industry	No. of Companies	In (%)
Manufacturing	45	60%
Services	20	26.7%
Others	10	13.3%

Source: Author's Research

Table 3: Description of the Sample on the Basis of Project Size

Project Size	No. of Companies	In (%)
More Than ₹ 50 lakhs	14	18.67%
More Than ₹ 1 Crore	23	30.67&
More Than ₹ 10 Crore	16	21.33%
More Than ₹ 100 Crore	13	17.33%
More Than ₹ 500 Crore	8	10.67%

Source: Author's Research

Table 4: Descriptive Study of the Dependent and Independent Data

Variables	PS	SCBA	FOT	TOT
Mean	1.68	.62	2.42	0.53
Median	1.00	1.00	2.00	1.00
S.D	1.27	0.48	0.91	0.50
Minimum	0.00	0.00	1.0	0.00
Maximum	4.00	1.00	5.00	1.00
Kurtosis	- 0.93	-1.76	- 0.26	- 2.03
Skewness	0.34	- 0.53	0.11	- 0.13

Source: Author's Research

Sample Statistics : The Table 4 presents the descriptive statistics of variables influencing the usage of capital budgeting techniques. PS is the project size of the firm. Firms indicated the usage of capital budgeting techniques for small projects also. In this case, the median is less than the mean, which indicates that most of the companies are following formal analysis of the projects with a small project size. The descriptive statistics of SCBA (social cost benefit analysis) indicates that more companies were using social cost benefit analysis as a factor to evaluate their capital investment projects. Kurtosis and skewness for all variables are within the range.

Results and Discussion

Expected Impact of PS and SCBA on the frequency of capital budgeting techniques (FOT) used by the Company

Regression Results for FOT as a Dependent Variable and PS as an Independent Variable : According to the Table 5, project size (PS) is found to positively influence the number of capital budgeting techniques applied by the decision makers. To put it differently, larger projects were found to be using more number of capital budgeting techniques to

Table 5: Regression Results for FOT and PS

Regression Statistics								
Multiple *R*	0.3376							
R Square	0.113973							
Adjusted *R* Square	0.101836							
Standard Error	0.869898							
Observations	75							
ANOVA								
	df	***SS***	***MS***	***F***	**Significance *F***			
Regression	1	7.105864	7.105864	9.390307	0.003056			
Residual	73	55.2408	0.756723					
Total	74	62.34667						
	Coefficients	**Standard Error**	**t Stat**	**P-value**	**Lower 95%**	**Upper 95%**	**Lower 95.0%**	**Upper 95.0%**
Intercept	2.018395	0.166855	12.09674	4.12E-19	1.685855	2.350936	1.685855	2.350936
PS	0.243019	0.079305	3.064361	0.003056	0.084964	0.401073	0.084964	0.401073

Source: Author's Research

evaluate the projects, and companies with smaller projects were using fewer number of techniques for evaluating the projects. The *t* -statistics and its coefficient is found to be significantly associated with the frequency of capital budgeting techniques. The *P* -value of 0.003056 indicates the significance of the variable project size (PS) at 95% level of confidence, which is also evident from the ANOVA table with *F* -value = 9.39 and the significant *P* -value is 0.003056. While introducing PS as an independent variable, with respect to frequency of capital budgeting techniques as a dependent variable, the adjusted R-Square is 0.101836. The results indicate that PS explains 10.18% variations in the frequency of the techniques. Hence, the hypotheses H01 is rejected and H1 is accepted since the regression results show that the firms with large project size use more number of capital budgeting techniques. It means that for companies with larger projects, the frequency of using different techniques for capital budgeting is high.

↳ **Regression Results for FOT as a Dependent Variable and SCBA as an Independent Variable :** SCBA (social cost benefit analysis) has a positive significant relation with the number of capital budgeting techniques applied by the company. It mainly advocates that the companies considering social cost benefit analysis were using more number of capital budgeting techniques to evaluate the projects and the companies focusing less on social cost benefit analysis were using lesser number of capital budgeting techniques. The *t* -statistics and its coefficient is found to be radically associated with the frequency of capital budgeting techniques. There is a significant relationship between SCBA and FOT, which can be derived from *P*-value = 0.08918.

The Table 6 highlights the significance of the variable SCBA (social cost benefit analysis) at 95% level of confidence, which is also apparent from the ANOVA table with *F*- value = 5.76 and the significant *P* value = 0.018918. If we look at the regression statistics, the adjusted *R*-Square is 0.060471. *R* square in the Table 6 shows that the independent variable SCBA (social cost benefit analysis) explains 6.05% variation in the dependent variable FOT (frequency of the capital budgeting techniques). Hence, it can be derived from the above results that the hypothesis H3 is accepted.

Expected Impact of PS and SCBA on Type of Capital Budgeting Techniques Used by the Company

↳ **Regression Results For TOT as a Dependent Variable and PS as an Independent Variable :** PS (project size) is significantly related to the type of capital budgeting techniques applied by the companies. In this case, the techniques have been categorized in two categories, one is non discounted techniques which is also known as traditional techniques, and the second is discounted techniques. The Table 7 indicates that the companies having bigger projects are using more of discounted cash flow (DCF) techniques like NPV, IRR, and discounted payback period ; the companies with the low project size were using traditional techniques like payback period and accounting rate of

Table 6: Regression Results for SCBA and PS

Regression Statistics								
Multiple *R*	0.270494							
R Square	0.073167							
Adjusted *R* Square	0.060471							
Standard Error	0.889705							
Observation	75							
ANOVA								
	df	***SS***	***F***	**Significance *F***				
Regression	1	4.56172	5.76282	0.018918				
	Coefficients	**Standard Error**	**t Stat**	**P-value**	**Lower 95%**	**Upper 95%**	**Lower 95.0%**	**Upper 95.0%**
Intercept	2.107143	0.168138	12.53219	7.14E-20	1.772043	2.442242	1.772043	2.442242
SCBA	0.509878	0.212397	2.40059	0.018918	0.086572	0.933185	0.086572	0.933185

Source: Author's Research

Table 7: Regression Results for TOT and PS

Regression Statistics								
Multiple *R*	0.396694							
R Square	0.157366							
Adjusted *R* Square	0.145823							
Standard Error	0.464185							
Observations	75							
ANOVA								
	df	***SS***	***F***	**Significance *F***				
Regression	1	2.9375	13.63311	0.000426				
	Coefficients	**Standard Error**	**t Stat**	**P-value**	**Lower 95%**	**Upper 95%**	**Lower 95.0%**	**Upper 95.0%**
Intercept	0.270833	0.089035	3.041874	0.003265	0.093387	0.44828	0.093387	0.44828
PS	0.15625	0.042318	3.692305	0.000426	0.071911	0.240589	0.071911	0.240589

Source: Author's Research

return as compared to discounting techniques. The *t* -statistics and its coefficient was found to be significantly related with the use of DCF capital budgeting techniques. The *P* -value = 0.000426 from the Table 7 indicates the significance of the variable PS (project size) at 99% level of confidence, with F-value = 13.63311. While establishing PS (project size) as an independent variable, with respect to type of capital budgeting techniques as a dependent variable, the adjusted *R* - Square is 0.1458. The results indicate that PS (project size) explains 14.58% variations in the type of capital budgeting techniques used by the companies. Hence, the hypothesis H02 is rejected and hypothesis H2 is accepted. These findings are consistent with the findings of Andrews and Butler (1986), Ross (1986), and Ryan, P. and Ryan, G. (2002). They also found that the firms with the larger project sizes use discounted cash flow techniques.

↳ **Regression Results for TOT as a Dependent Variable and SCBA as an Independent Variable :** SCBA (social cost benefit analysis) is positively related to the type of capital budgeting techniques applied by the companies. The Table 8 indicates that the companies using social cost benefit analysis were using more of discounting cash flow (DCF) techniques and the companies which did not take the social cost benefit analysis into account were using less of the discounting cash flow techniques. The *t* - statistics and its coefficient is found to be significantly associated with the use of DCF capital budgeting techniques. As per the Table 8, the *P* - value = 0.000693, which indicates the significance of the variable PS (project size) at 99% level of confidence. From the ANOVA table, we can see that the *F* - value is 12.5567, which is quite significant. While assessing SCBA (social cost benefit analysis) as an independent variable, with respect to type of capital budgeting techniques as a dependent variable, the adjusted *R* - Square is 0.1350. The

Table 8: Regression Results for TOT and SCBA

Regression Statistics								
Multiple *R*	0.383099							
R Square	0.146765							
Adjusted *R* Square	0.135077							
Standard Error	0.467096							
Observations	75							
ANOVA								
	df	***SS***	***F***	**Significance *F***				
Regression	1	2.739615	12.5564	0.000693				
	Coefficients	**Standard Error**	**t Stat**	**P-value**	**Lower 95%**	**Upper 95%**	**Lower 95.0%**	**Upper 95.0%**
Intercept	0.285714	0.088273	3.236717	0.001819	0.109787	0.461642	0.109787	0.461642
SCBA	0.395137	0.111509	3.543549	0.000693	0.1729	0.617373	0.1729	0.617373

Source: Author's Research

results indicate that variations in SCBA (social cost benefit analysis) explains 13.50% variations in the type of capital budgeting techniques used.

After analyzing the results given in the Table 8, it can be concluded that the hypothesis H4 is accepted, and the hypothesis H04 is rejected. The results are consistent with the findings of Gupta and Mohanty (2012).Hence, the variables such as project size and adoption of social cost benefit analysis were found to have a significant relationship with the usage of capital budgeting techniques. Both the factors have a significant positive relationship with the usage of capital budgeting techniques. The findings are consistent with the findings of Klammer (1972), Andrews and Butler (1986), Ross (1986), Graham and Harvey (2001, 2002), Anand (2002), Ryan, P. & Ryan, G. (2002), and Hermes, Smid and Yao (2007).

Conclusion

This paper investigated the determinants of the capital budgeting technique with reference to Indian corporates. By using the regression model with a sample of 75 companies, the study has found that PS (project size) and SCBA (social cost benefit analysis) are significantly and positively related with both the dependent variables - FOT (frequency of techniques) and TOT (type of techniques). It was also found that PS (project size) and SCBA (social cost benefit analysis) are significantly related to FOT at 95% level of confidence , and PS (project size) and SCBA (social cost benefit analysis) are highly significantly related with TOT at 99% level of confidence. On the basis of the analysis, it can be concluded that companies with bigger project size use discounted capital budgeting techniques and the frequency of using capital budgeting techniques is also high. Also, the companies which are applying SCBA (social cost benefit analysis) use more of the discounted capital budgeting techniques. This paper would help the analysts and researchers to understand the determinants of capital budgeting techniques in a company.

Research Implications

The present study has conducted a survey of companies to understand the usage of capital budgeting techniques by firms in India. This research has answered many questions related to application of capital budgeting techniques like:

- Whether companies are applying more than one technique for evaluation of the project.
- Whether the project size affects the application of capital budgeting techniques.
- Whether firms are using the social cost benefit concepts while evaluating a project and how far companies' capital budgeting decisions are influenced by the application of social cost benefit application (SCBA).
- The independent variables are regressed with one new dependent variable as the frequency of capital budgeting techniques used by the firms signifies the number of techniques adopted by the firm to take the final decision which has not been considered in previous research works. This will help the researchers to know about the influence of the independent variables on the number of techniques applied by the firms.

↳ This research studied a variable - social cost benefit - which may have an impact on the selection of capital budgeting techniques. This shows that nowadays, companies are also going for evaluation of social and environmental benefits before choosing a project. This study gives an idea of adoption of SCBA by the Indian firms and the impact of this variable on the capital budgeting decisions.

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Annexure 1: List of the Companies

Beltron	Central Coalfield Ltd.	NALCO
Rector Mines	Agni Power and Electronics Pvt. Ltd.	MOIL
IDCOL	Orissa Drugs & Chemicals Ltd.	KFC
Indian Oil	AB Excavators	UFLEX Ltd.
McKinsey	ECIL	EIL
Acme Exports	A and B Corp	Sanfab India
Pristine leather	AV systems	M/s PTEW
OPGC	ICO Ltd.	SAIL
Delloite	Gupta Power Infra	Parle Products
Tech Forging	Mecon Ltd.	Vodafone
CESU	Acrux Realcon Pvt. Ltd.	SCI
McKinsey Agro	GIPL	MMTC Ltd.
OPTCL	AD Electrosteel Pvt.	Rathi Steel and Power
AB Construction	OMC	Ltd.
OHPC	DA Meteo	
Sadhu Tubes Pvt. Ltd.	IMFA	
Unique Enterprise	PPL	
Usha Polyplast	Ragunath Rai and Co.	
Legend Alloys Pvt. Ltd.	Visuvius India Ltd.	
Ornate Lables Pvt. Ltd.	Turtle Ltd.	
TCS	Delta Fabrics Priv. Ltd.	
BPCL	Sree Bala Pvt. Ltd.	
AHLL	Shree Ganesh Ltd.	
G.D. Food	Vijay Enterprise	
Indian Manuf. Co.	Steel Crackers pvt	
BBJ Construction Co. Ltd.	Asian Tea and Export	
Coal India Ltd.	Netwing commn Pvt. Ltd.	
Ortel Communications	Nipa India Pvt. Ltd.	
HLL Life Care	Larsen & Toubro	
Aaltex International	IMFA	
ABC India Ltd.	PPL	