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Capital budgeting practices: evidence from Sri Lanka

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Abstract

Purpose – The purpose of this paper is to investigate prevailing capital budgeting practices in Sri Lankan listed companies.

Design/methodology/approach – A comprehensive primary survey was conducted of 32 out of 46 chief financial officers (CFOs) of manufacturing and trading companies listed on the Colombo Stock Exchange in Sri Lanka. Garnered data were then analyzed using appropriate statistical techniques.

Findings – The results revealed that net present value (NPV) was the most preferred capital budgeting method, followed closely by payback (PB) and internal rate of return (IRR). Similarly, sensitivity analysis was regarded as the dominant capital budgeting tool for incorporating risk and the widely used method for calculating cost of capital was the weighted average cost of capital. Moreover, results revealed that size of the capital budget affects the use of the capital budgeting methods (NPV, IRR and PB) and incorporating risk tool (sensitivity analysis and simulation). Further, results revealed that CFOs had higher educational qualification were preferred to use sophisticated capital budgeting practices dominantly NPV, IRR and incorporating risk tool of sensitivity analysis although they were found to be reluctant in use of accounting rate of return. In a similar vein CFOs with higher experience were preferred using IRR and sensitivity analysis.

Originality/value – This study contributed to academics, practitioners, policy makers and stakeholders of the company. Moreover, this research has proffered a more reliable and comprehensive analysis of capital budgeting practices in Sri Lankan listed manufacturing and trading firms. Since Sri Lanka is an unexplored country on capital budgeting practices, this research was originally contributed to the extant literature *per se*.

Keywords Sensitivity analysis, NPV, Risk, Financial management, Capital budgeting, IRR, WACC

Paper type Research paper

Introduction

Primary objective of financial management is to maximize the shareholders' wealth and principally concerns with three major decisions on investment (what to invest), financing (how to finance) and dividend decisions (how to reward shareholders) and interactions between them (Freeman and Hobbes, 1991). The survival of a company depends very much on its ability to generate returns from its investments (Mustapha and Mooi, 2001; Ryan and Ryan, 2002) and it deserves organizational operations. The capital budgeting theory lies within the concept of shareholders' wealth maximization (Pike, 1988; Slagmulder *et al.*, 1995) and involves investment decisions in which expenditures and receipts continue over a significant period of time (Copeland and Weston, 1992; Peterson and Fabozzi, 2002; Dayananda *et al.*, 2002). Growing finance literature pointed out that "the steady increase in the variety and scale of uncertainties, competitive interactions and risks prevail, and the difficulty to make reasonable

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