AUTHORS
Dr. A. K. Garg
Reader,
Dept. of Commerce,
A.S. (P.G.) College,
Sikandrabad (U.P.)

Vipin Kumar Garg
Research Scholar

Capital Budgeting Decision Mechanism

An appraisal of Escorts India Ltd.

ABSTRACT

The investment proposals need to be related to the under lying corporate objectives and strategies. Capital expenditure decisions usually involve large sums of money, have time-spans and carry some degree of risk and uncertainty, hence realistic investment appraisal required.
The present paper concentrates on the investment evaluation criteria of Escorts India Ltd.

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1. INTRODUCTION

Capital Budgeting is the art of finding assets that are worth more than they cost, to achieve a predetermined goal i.e. optimizing the wealth of a business enterprise. The investment proposals need to be related to the underlying corporate objectives and strategies. A key challenge for all organisations is to identify projects, which fit these strategies and promise to be profitable in the broadest sense i.e. to create wealth for the organisation. Capital expenditure decisions usually involve large sums of money, have long-time spans and carry some degree of risk and uncertainty.

A capital investment decision involves a largely irreversible commitment of resources that is generally subject to significant degree of risk. Such decisions have a far reaching efforts on an enterprise's profitability and flexibility over the long-term. Acceptance of non-viable proposals acts as a drag on the resources of an enterprise and may eventually lead to bankruptcy.

2. INVESTMENT INCENTIVES

Investment incentives take a variety of forms, including rates relief, rent free period for land and buildings, and lum-sum grants towards the costs of an investment project. The incentives may be offered by either central or local government, but the primary purpose, which they are intended to serve is to attract investment and, in particular, employment generating investment, into areas, which would otherwise be regarded as unattractive. There are two basic types of investment incentives, cash grants and accelerated depreciation allowance.

(i) Cash grants : When these are receivable they should be brought into the project appraisal in the period in which they are receivable.

(ii) Capital Allowances : These allowances have an equivalent cash inflow value of assuming sufficient profits are being earned to cover all the allowances.

Taxation effects a project in the following ways:

(a) Corporate taxes on project profits and losses,

(b) Investment incentives (cash grants and/or capital allowances),

(c) The reduction of the WACC because interest payments are allowable against tax.

3. INVESTMENT EVALUATION CRITERIA

In Escorts (I) Ltd. took following three steps in the evaluation of an investment decision:

* Estimation of cash flows,
* Estimation of the required rate of return,
* Application of a decision rule for making the choice.

The investment decision rules may be referred to as capital budgeting techniques or investment criteria. A sound appraisal technique issued to measure the economic worth of an investment project. The main features of a sound investment evaluation criterion:

(a) It should consider all cash flows to determine the true profitability on the project,

(b) It should provide for an objective and unambiguous way of separating good projects from bad projects,

(c) It should help ranking of projects according to their true profitability,

A number of capital budgeting techniques are in use in Escorts (I) Ltd. for taking capital investment decision. These may be grouped as:

1. Discounted Cash Flow Criteria :

* Net Present Value (NPV)
* Internal Rate of Return (IRR)
* Profitability Index (PI)
* Discounted Payback Period.

2. Non-discounted cash flow criteria :

* Payback period,
* Accounting Rate of Return

The net present value criterion is the most valid technique of evaluating an investment project in Escorts (I) Ltd. because it is generally consistent with the objective of maximizing the share holders' wealth.

An analysis of fund and various capital assets in **Escorts (I) Ltd.** In 2001 Net Block of Fixed assets registered an increase of Rs. 135.25 thereby increasing the percentage by 0.87. In 2002, it further increased by Rs. 137.97 with a percentage increase of 7.43 and a decrease of Rs. 789.73 (-4.97%) in 2003 as compared to year 2002 and 2001 respectively.

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TABLE 1 : NET BLOCK OF FIXED ASSETS

Year	Amt. In Lacs	Net Increase or Decrease	% increase or decrease as compared to previous year
2000	15288.96	--	--
2001	15424.21	+ 135.25	+ 0.87
2002	16662.18	+ 1237.97	+ 7.43
2003	15872.45	-789.73	- 4.97

Source: Various annual reports of the company.

In 2001 Income decreased by Rs. 7145.39 thereby decreasing the percentage by 38.52. In 2002, it further decreased by Rs. 892.16 with a percentage decrease of 5.05 and on increase of Rs. 2843.47 (+13.87%) in year 2003.

As compared to year 2002 and 2001 respectively.

TABLE 2
COMPARISON OF INCOME DURING THE PERIOD 2000 TO 2003

Year	Amt. In Lacs	Net Increase or Decrease	% increase or decrease as compared to previous year
2000	25693.77	--	--
2001	18548.36	- 7145.39	- 38.52
2002	17656.22	- 892.16	- 5.05
2003	20499.69	+2843.47	+ 13.87

Source: Various annual reports of the company.

4. CONCLUSION

An analysis of Capital Budgeting in Escorts (I) Ltd. indicates that all alternative options as to purchase of machinery including capital expenditure like heavy repair and maintenance are explored. A detailed analysis as to the present value of cash inflows and outflows

Table 3 : Capital Budgeting Decision Regarding Cost of Platean Honing Machine Purchased by Escorts (I) Ltd.

Cash Outflows	**(in Rs.)**
1 Cost of Machine	65,00,000
4 Tools @ 350,000	14,00,000
4 Pairs Rubber @ 5000	20,000
4 Carrier @ 25000	1,00,000
	80,20,000
Excise Duty @ 15%	12,03,000
	92,23,000
C.S.T. @ 4% (C Form)	3,68,920
	95,91,920
Transit Insurance @ 25%	24,220
Stabilizer 20-24 KVA	80,000
Civil and Electrical Exp.	30,000
Packing & Forwarding Charges	95,920
	98,22,060
Less Modvat	12,03,000
	Rs. 86,19,060

Source: Company Records

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is made, so as to select right type of machinery.

Various risk adjusted techniques of statistics and other branches of management are also used in order to evaluate risky budgets. There is excessive blockage of funds in Capital Assets and it is suggested that an effort should be made to reduce heavy investment in fixed assets unless, it is essential. Capital information system should be designed so as to take timely decision as to capital assets. Capital expenditure control mechanism should also bee evolved. It is also suggested that a strategic approach should be adopted to take decision regarding capital budgets.

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