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Capital Investment Appraisal

Elaine Pamela Harris and Moataz El-Massri

1 Introduction

Capital budgeting or investment appraisal is concerned with organizational management decisions about which projects or assets to invest in and how to finance them to achieve corporate goals. The background to this area of management accounting started by defining this as a routine part of the budgetary control system, hence the label 'capital budgeting' still used in many texts and organizations today. Investment appraisal techniques traditionally applied the principles of economics to asset replacement and expansion decisions, largely ignoring the wider context of strategy formulation and implementation; thus, non-financial factors and risk levels were not always fully appraised. Whilst this may have suited the relatively stable manufacturing environments of the post-war Anglo-American countries, it has become far less suitable in recent times and other international contexts.

This chapter aims to show, through a systematic review of literature, how our understanding of capital investment appraisal has developed from an economic concept over the last 30-or-so years, and how behavioural studies contribute to what is now recognized as a strategic process. In order to achieve this aim, the chapter is organized as follows; section one traces the development of the theory, concepts and process involved in investment appraisal, from its capital budgeting roots. Techniques used in investment appraisal are outlined and critiqued in section 2, and the case is made for two new dimensions, organizational context and managerial judgement, to be considered. Section 3 discusses the practice of investment appraisal and the importance of strategic dimensions through a review of mainly case-based literature. The behavioural studies reviewed were identified by Emmanuel, Harris

and Komakech (2010) and impact on how we understand this area of research today. Finally, in section 4, conclusions are drawn for how far research in this area of management accounting has come, and suggestions for further research are made.

1.1 Development of the capital budgeting concept

The term 'capital budgeting' has its origins in the relatively stable market and economic conditions experienced post-Industrial Revolution, where simple products were produced using unsophisticated processes, so a capital budget was simply an annual budget for capital expenditure, or asset-replacement plan for fixed assets used in manufacturing. This form of capital budget was developed through assumptions about capacity, productivity, product life cycles, asset specificity, market demand, prices of fixed assets and estimated useful lives, as a form of management accounting. The main decisions involved were when to replace assets, whether to lease or buy them and whether to upgrade equipment to new models.

Financial management principles developed this further with a focus on long-term decision making to maximize shareholders wealth. Management should be able to decide which long-term investment alternatives will be worthwhile. To do this, decision makers could use management accounting tools and techniques in order to evaluate a specific investment's ability to generate optimum cash flows in order to maximize shareholders wealth. This broadened the definition of 'capital budgeting' to 'making of long term planning decisions for investments in projects and programmes' (Horngren, Foster and Data 2000, p748). Dayananda et al. (2002) argued that a capital budget is concerned with sizeable investment in long-term assets. Gitman (2008, p380) defined the capital budget as a 'process of evaluating and selecting long term investments that are consistent with the business's goal of maximising owner wealth'. From these definitions, it can be noticed that capital budgeting today is more concerned with long-term or strategic investments, for example, new products, processes, technology, markets, supply chains, mergers and acquisitions. Also it can be concluded that the maximization of shareholders' wealth is still assumed to be the most important objective for business organizations. We will consider other types of organization later.

Even for manufacturing companies, capital budgeting can be criticized for not keeping up with changes in product complexity, advanced manufacturing technology (AMT), work practices, globalization of markets, shorter product life cycles, computer-aided design and manufacturing