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CAPITAL INVESTMENT PRACTICES IN THE BANKING INDUSTRY IN SRI LANKA: AN EMPIRICAL STUDY

by

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CANDIDATE'S DECLARATION

The work described in this thesis was carried out by me under the supervision of Dr. Samanthi Senaratne, Department of Accounting, University of Sri Jayawardenepura and a report on this has not been submitted in whole or in part to any university or any other institution for another degree.

.... May 22, 2010

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SUPERVISOR'S DECLARATION

I certify that the above statement made by the candidate is true and that this thesis is suitable for submission to the University of Sri Jayawardenepura for the purpose of evaluation.

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Abstract

With the underlying motive of filling the gap in the empirical evidence relating to capital investment practices, this study is largely a survey of capital investment practices in Sri Lankan banks. Conceptualization and modeling of the survey was backed by literature on such research conducted in Western nations and some selected Asian countries. This research serves the purpose of revealing the actual management practices related to capital investment decisions in the Sri Lankan context and of providing a research account for the enhancement of such practices.

Being a survey research, the study focuses on the banking industry in Sri Lanka and therefore all banks, commercial as well as licensed specialised banks operating in the country were selected for the study. Out of a sample of 36 banks operating in the country, the researcher was able to obtain 22 responses which amounted to a response rate of 61%.

It is pertinent to mention that, some of the banks selected for the study are huge in size and some are relatively small. For the purpose of the research, banks selected for the study were categorised into three groups: small, medium and large on the basis of turnover. The purpose of categorizing is to identify different capital investment practices if any, employed by banks based on the size of the bank. Then differences in the actual practices among these categories were tested using inferential statistics as well as descriptive statistics. The principal data collection method of the survey was a personally administered questionnaire covering the conceptual dimensions of the survey model.

Conceptually, the survey concentrated on two major dimensions of the capital investment process: general issues and technical issues of capital investment practices. General issues therein mainly dealt with the interaction between the capital investment process and the overall organisational interface of strategic decision making. Technical issues covered the procedural, evaluative and problematic aspects of the capital investment process.

The study revealed that majority of the Sri Lankan banks considered the capital investment process as important. Improve the cost efficiency and maximization of customer satisfaction had been assessed as the most important objectives in this process. Majority of banks generate capital investment ideas at top organizational level.

All banks carry out primary and secondary evaluation mainly by the specialised internal staff on the identified capital investment. Board of Directors and a special committee appointed takes the ultimate decision on capital investment. All banks have imposed limits on capital investment. Majority of banks carry out evaluation to assess the best source of funding and carry out post audits as well.

Majority of Sri Lankan banks are familiar with discounted cash flow techniques and more weightage is given to quantitative factors when selecting a capital investment technique. 'Theoretically correct' and 'Easy to understand' are the two main criteria used by banks in selecting a capital investment technique. All banks use the NPV to evaluate capital investment projects. 'Judgment based return' and 'Judgment of opportunity cost' are the most commonly methods used to estimate the required rate of return and determine the cost of equity respectively. Sri Lankan banks use sophisticated capital investment techniques with due emphasis on risk considerations and the decision of the cost of capital had been identified as the most difficult problem in the capital investment process.

This survey research, it is believed, will help to develop a rational and theoretically valid managerial perspective on capital investment practices of organisations in the financial service industry as a whole and banks in particular, which in turn will contribute to the socio-economic development of the nation and of the region.

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1.1 Problem Background

Capital investment, an area coming under management accounting, has been developed to a great extent during the last five to six decades. However, there are many untapped areas in this field of study, especially the area of decision making, which has not been researched in depth in the recent past. This may be due to the many behavioral factors involved in the decision making process.

In the past, several surveys of capital budgeting practice have been carried out. Survey results of capital budgeting practices have been reported in the literature since the late 1950s. Most surveys focus on companies in the U.S. This is especially true for surveys carried out before the 1980s. Some later studies are based on information from Canadian, Australian and European companies. Several surveys have been carried out on this area in East-Asian countries too in the recent past.

In fact, capital investment appraisal is one of the subjects in the degree programs conducted by the universities and affiliated Universities both here and abroad. In addition, this area is thoroughly covered in professional exams conducted by the Institute of Chartered Accountants of Sri Lanka (ICASL), Chartered Institute of Management Accountants (CIMA), Association of

Certified Chartered Accountants (ACCA) and Certified Financial Accountants (CFA). All students under these programs are taught capital investment decision-making theory in depth. However, there is no evidence to say that they follow the methods taught as theory when it comes to making capital investment appraisals. This is one of the criticisms made about the higher education system in Sri Lanka. Therefore, the researcher strongly feel that there is a considerable gap between the theoretical knowledge and the practical aspects of this field of study. This study would be one of the responses to this desperate need in the present higher education system in Sri Lanka.

The Government of Sri Lanka has been encouraging the private sector after the liberalization of the economy in 1977. A large part of the Sri Lankan economy is being dominated by the private sector as the engine of economic growth while the public sector's role in economic development is very small - just fueling the economic engine.

The contribution from the public sector has been declining after 1977 due to the open economic policies. Over 90 percent of the industrial production of Sri Lanka was contributed by the private sector (Central Bank Annual Report, Sri Lanka 2003, p.110) during the period from 1999 to 2003.

It is important to note that the social, cultural, legal and organisational practices of a country like ours cannot be compared with those of a developed country. Infrastructure facilities in Sri Lanka are at the infant stage when compared with developed countries and technological knowledge and capabilities and education systems are far behind theirs. Their organisational practices, policies, systems and procedures are far superior when compared to Sri Lanka. However, our country follows systems, procedures and policies mostly developed by these capitalistic countries.

Capital investment practices are one such area where the organisations in Sri Lanka are following the foot path of the western countries. Manufacturing as well as service organisations invest enormous amounts of money on capital expenditure. Manufacturing organisations generally invest in premises, plant and equipment, information technology, etc. On the other hand, service organisations invest in premises, information technology, interior decoration and so on. Sometimes, service organisations have to invest in human resources capital as well. However, both these sectors are compelled to make substantial investments in capital expenditure at regular intervals.

Service sector organisatons play a dominant role at present in the Sri Lankan economy. This sector had contributed approximately 60 percent to the GDP for the years 2007 and 2008 respectively (Central Bank Annual Report, Sri Lanka 2008, National Output and Expenditure, Table 2). In addition, 41.0 per cent of the work force is attached to the service sector (Central Bank Annual Report, Sri Lanka 2008, p.97). The banking, insurance and real estate is one important sector in the service category. The contribution from this sector to the overall service sector was approximately 15 percent for the years 2007 and 2008