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ARTICLE

Capital budgeting practices in Spain☆

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Abstract This paper seeks to shed further light on the capital budgeting techniques used by Spanish companies. Our paper posits that the gap between theory and practice might be related to the nature of sources of value and to the efficiency of mechanisms aligning managerial and shareholder incentives, rather than to resource restrictions or model misinterpretation. We analyze data from a survey conducted in 2011, the final sample comprising 140 non-financial Spanish firms. Our findings show a behaviour pattern similar to that reported in prior research for firms in other countries. Particularly noteworthy is that payback appears to be the most widely used tool, while real options are used relatively little. Our results confirm that size and industry are related to the frequency of use of certain capital budgeting techniques. Further, we find that the relevance of growth opportunities and flexibility is an important factor explaining the use of real options.
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Introduction

Widespread opinion among scholars and practitioners is that a firm's future success and survival ultimately depend on it getting its current investment decisions right. In their renowned handbook on Corporate Finance, Brealey, Myers and Allen state that a good investment remains good business even if it is not optimally financed, but that a bad investment will be a wrong decision even with the best financing policy (Brealey et al., 2010). Paradoxically, Michael J. Brennan noted that in 1995 a finance instructor had much more to say about financial policy than about capital budgeting (Brennan, 1995).

Recent financial research has helped cover some of the gaps in the investment decision-making problem from various angles. Agency theory has helped us understand that certain inefficiencies observed in corporate investments may be explained by the conflict of interests between insiders and outsiders in a context of imperfect information. Behavioural finance has shown how cognitive biases determine unintended decisions made by financial managers. The real options approach has provided new tools suited to reflecting the value of both the tangible and intangible results to emerge from corporate resource allocations. Finally, the literature on corporate finance practices has helped pinpoint and explore the gap between theory and practice.

Our paper focuses on the latter research line, which emerged over half a century ago with Miller's (1960) and Istvan's (1961) studies on capital budgeting practices in U.S. companies, and has subsequently been updated and has spread with evidence from a wide range of countries. As a whole, this literature reveals that managers use multiple techniques, some of which are theoretically appropriate, while others are less so. The most popular evaluation techniques are Net Present Value (NPV), Internal Rate of Return (IRR), and Payback (PB), along with more sophisticated models, such as real options and simulation. Besides extending and empirically illustrating the use of different theoretical stringency techniques, these studies suggest that certain firm characteristics – such as size – and managerial factors – such as education – may help to explain the choice of capital budgeting tools.

The purpose of this paper is twofold: firstly, to extend and update the empirical evidence available on capital budgeting practices in Spanish companies; and, secondly, to shed further light on the factors explaining the choice of capital budgeting tools by examining the possible influences of sources of value creation and mechanisms aligning managerial and shareholder incentives. According to our hypothesis, the 'theory–practice' gap may be partially explained by (i) the relevance of growth options and flexibility among a firm's sources of value and (ii) the effectiveness of governance mechanisms such as debt or managerial ownership in aligning interests. Should these hypotheses prove to be right, using of more simple practices may merely be a question of convenience or suitability rather than companies' resources restrictions or managers' lack of knowledge.

The empirical approach is performed using information obtained from a total of 140 questionnaires answered by Chief Financial Officers (CFOs) of Spanish companies in February 2011. As with evidence from other countries, our analysis indicates that CFOs adopt investment decisions based on information from combining multiple capital budgeting methods. Results indicate that the most commonly used techniques, in order, are as follows: PB, IRR and NPV, with few companies using real option models. How often discounted cash flow techniques are used is partially driven by the variables of industry and company size. CFO profile does not appear to be a relevant factor in explaining capital budgeting practices in Spanish firms. Regarding real option models, our results indicate that their use depends mainly on the relevance of flexibility and growth options as company value sources and, to some extent, on certain incentive alignment mechanisms.

The remainder of the work is organized as follows: the second section reviews previous literature. The third section sets out the hypotheses. The fourth section describes data collection, sample and econometric models. Descriptive results as well as the test of explanatory hypotheses are shown and discussed in the fifth section. The work concludes with a discussion of the main results and limitations.

Theory and practice of capital budgeting practices

Interest in understanding the practices used by CFOs when deciding which investment opportunities to undertake first emerged in the early 60s. Studies by Miller (1960) and Istvan (1961) on U.S. companies herald the beginning of a series of diagnostics in companies worldwide, which continues to the present day. Evidence in the 60s and 70s reflected a certain managerial tendency to gradually use theoretically superior models based on discounted cash flows. At the same time, certain studies began to report an increasing gap between financial theory and firms' practices. Through an in-depth analysis of eight cases, Mao (1970) found that managers preferred to use simple tools such as PB or the accounting profit criteria, as opposed to models which were more appropriate from a theoretical perspective, such as NPV or IRR. Two years later, Klamer (1972) concluded that the ''new'' advanced theory in the 50s was put into practice as of the 70s.

Since then, the 'theory–practice' gap has continued to grow, firstly due to greater scientific production in finance and secondly due to the gradual adoption of new capital budgeting tools by firms, similar to the gradual acceptance of other corporate decision-making techniques (Triantis, 2005), but lagging far behind the speed with which entrepreneurs have embraced other kinds of innovations.

Recent literature shows that, broadly speaking, managers continue to use simple tools which are theoretically less appropriate and accurate, while more recent and sophisticated techniques are relegated to analyzing specific investment projects in just a few large companies (Verbeeten, 2006). From a theoretical standpoint, the most widely recommended 'Corporate Finance' handbooks have preached the superiority of models such as NPV and real options since the mid-nineties.[3] Said academic literature establishes that NPV and real option models provide a direct

[3] See, among others, Richard A. Brealey, Stewart C. Myers and Franklin Allen: *Principles of Corporate Finance* (McGraw-Hill/Irwin)

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