CAPITAL BUDGETING

Capital budgeting is a process of evaluating proposed projects to determine which ones are deserving of an investment. Ideally, businesses should pursue all projects and opportunities that enhance shareholder’s value. However, because the amount of capital available at any given time for new projects is limited, management needs to use capital budgeting techniques to determine which projects will yield the most return over an applicable period of time.

Features of Capital Budgeting:

* It involves high risk
* Large profits are estimated
* Long time period between the initial investments and estimated returns

Importance of Capital Budgeting:

* It creates a framework for businesses to develop and formulate long term strategic goals.
* It enables executives to estimate and forecast future cash flows of a potential project.
* It helps to seek and evaluate new investment projects, an important function for all businesses as they seek to compete and earn profit in the industry.
* It helps monitoring and control expenditures by defining a budget carefully for the given project.
* It helps in creation of decision rules that can categorize which projects are acceptable and which are not.
* It facilitates the transfer of information to the appropriate decision makers within the company.
* It creates accountability and measurability as it helps businesses to understand the risks and returns involved in any investment project.
* Proper capital budgeting leads to proper timing of assets-acquisition and improvement in quality of assets purchased.

* It facilitates the wealth maximization of equity shareholders by selecting the most profitable projects.
* It assists in formulating a sound depreciation and assets replacement policy.

Process of Capital Budgeting:

1. Identify long-term goals of the individual or business.
2. Identify potential investment proposals for meeting the long-term goals identiﬁed.
3. Estimate and analyze the relevant cash ﬂows of the investment proposal identiﬁed.
4. Determine ﬁnancial feasibility of each of the investment proposals by using the capital budgeting methods.
5. Choose the projects to implement from among the investment proposals outlined.
6. Implement the projects chosen.
7. Monitor the projects implemented as to how they meet the capital budgeting projections and make adjustments where needed.

Factors Affecting Capital Budgeting Process:

* Availability of Funds
* Structure of Capital
* Management decisions
* Accounting methods
* Taxation policy
* Lending terms of financial institutions
* Working Capital
* Capital Return
* Need of the project
* Government policy
* Economic value of the project

Capital Budgeting Techniques/Methods:

There are different methods adopted for capital budgeting.

The traditional or non-discounted methods include:

* Payback period
* Accounting rate of return method

The discounted cash flow methods include:

* Net Present Value (NPV) method
* Profitability index method
* Internal Rate of Return (IRR)

Each of the method has its own advantages and disadvantages. Each one provides a different perspective on the capital investment decision. It depends on the company to use the methods according to their need and suitability.

Conclusion:

As selection of project is a major investment decision for any organization, any wrong selection of a project may incur heavy losses for the organization. In addition, the reputation and goodwill of the organization may also get affected. Capital budgeting method has a great importance as it helps in planning capital required for completing long-term projects.