CAPITAL BUDGETING

Dr. P.S.M.L. Vasantha,
Dept of Commerce (PG)
HMV

MEANING:

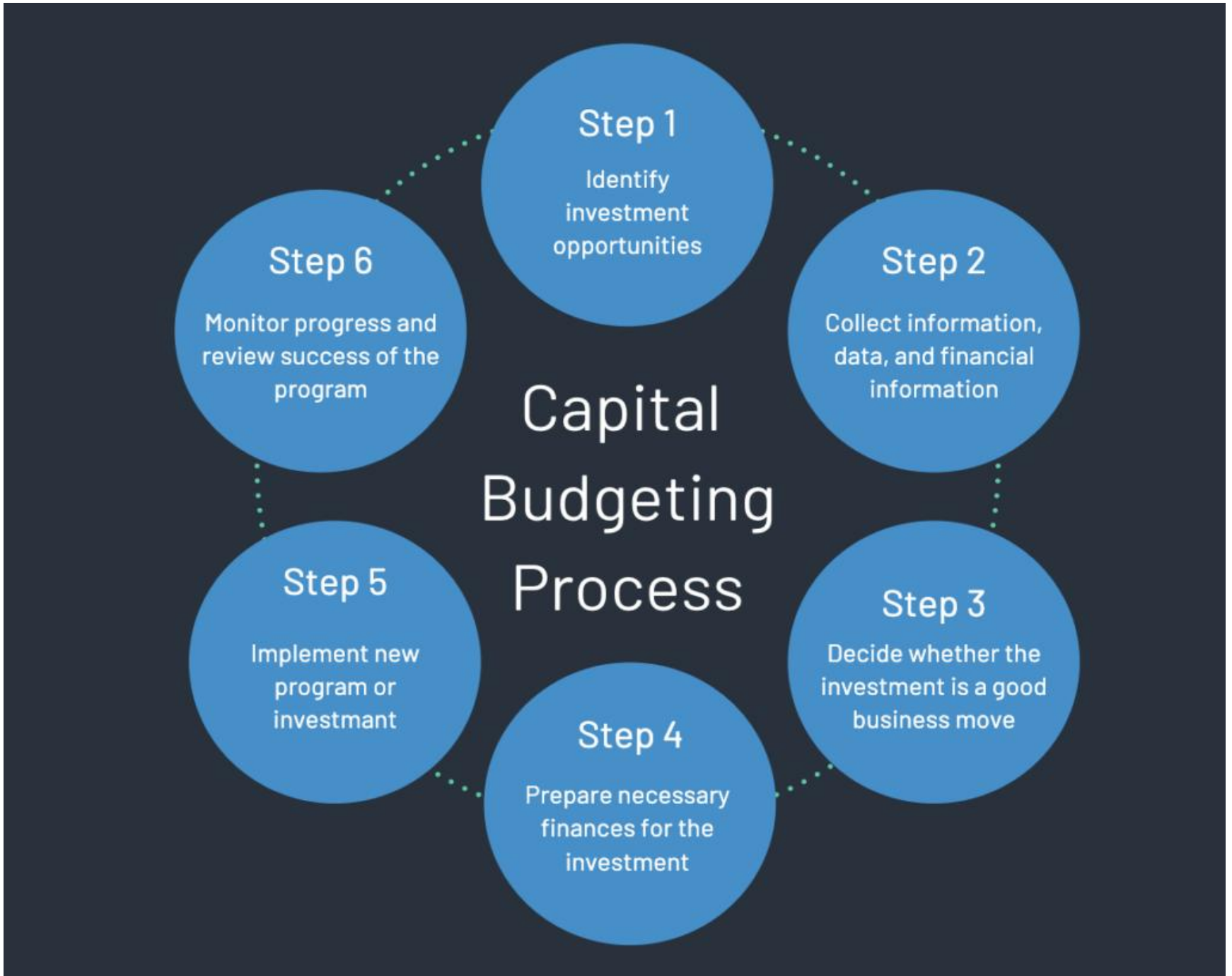
- Capital Budgeting is defined as the process by which a **business determines which fixed asset purchases or project investments** are acceptable and which are not. Using this approach, each proposed investment is given a **quantitative analysis**, allowing rational judgment to be made by the business owners.

NEED OF CAPITAL BUDGETING:

- Long term projects
- Expansion or creating additional capital
- Replacement of assets

IMPORTANCE:

- Long term commitment of funds
- Large investments
- Irreversible nature
- Long term effect on profitability
- Difficulties of investment decisions
- National importance

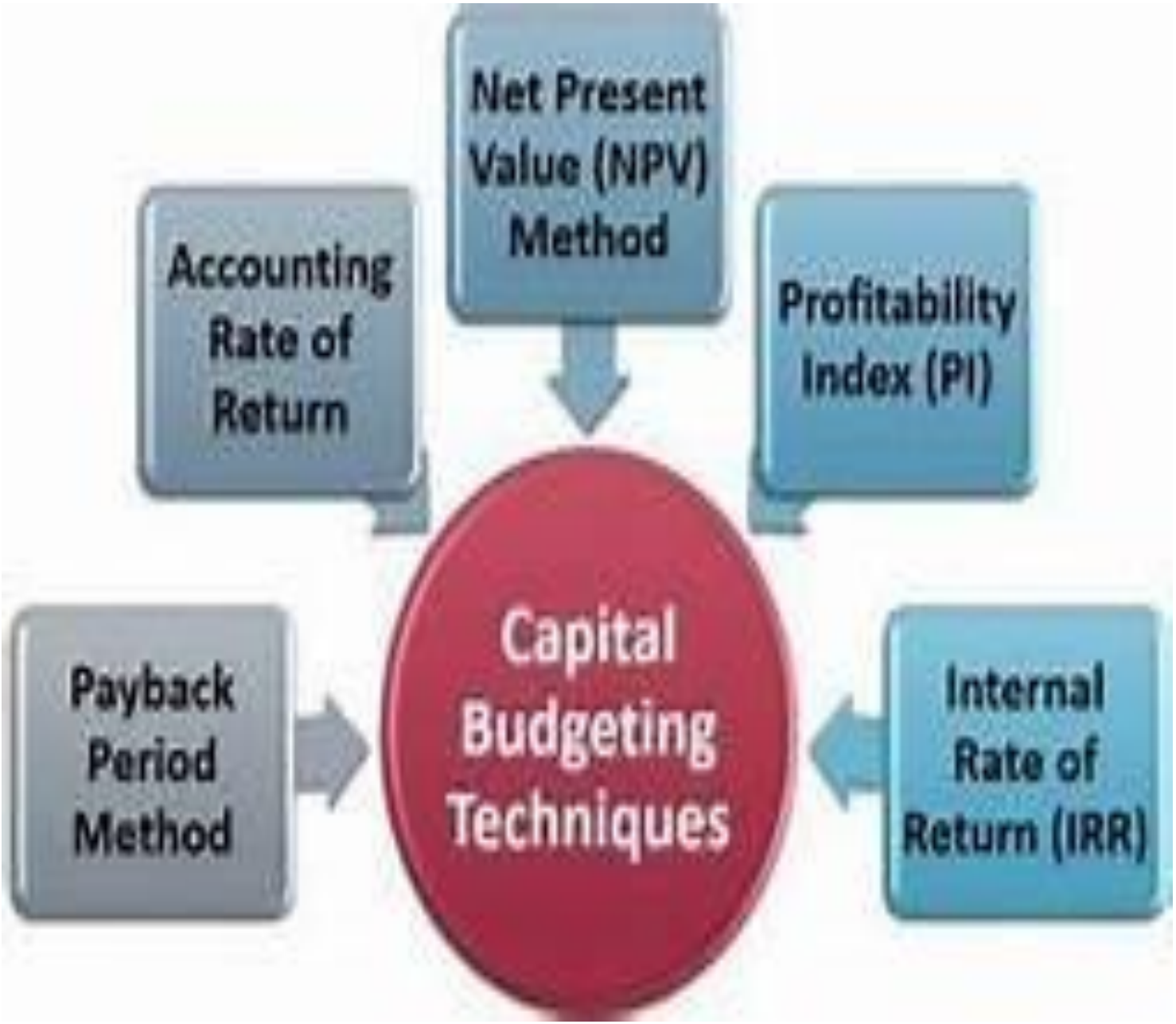

Capital Budgeting Process
Step 1
Identify investment opportunities
Step 2
Collect information, data, and financial information
Step 3
Decide whether the investment is a good business move
Step 4
Prepare necessary finances for the investment
Step 5
Implement new program or investmant
Step 6
Monitor progress and review success of the program

KINDS OF CAPITAL BUDGETING DECISIONS:

- Increase revenue
- Reduce costs
- Accept reject decisions
- Mutually exclusive project decisions
- Capital rationing decisions

FACTORS AFFECTING CAPITAL BUDGETING

- Capital Return
- Accounting Methods
- Structure of Capital
- Availability of Funds
- Management decisions
- Government Policies
- Working Capital
- Need of the project
- Lending terms of financial institutions
- Earnings
- Taxation Policies
- The economic value of the project


Net Present Value (NPV) Method
Accounting Rate of Return
Profitability Index (PI)
Capital Budgeting Techniques
Payback Period Method
Internal Rate of Return (IRR)

Payback Period Method

- In this technique, the entity calculates the time period required to earn the initial investment of the project or investment. The project or investment with the shortest duration is opted for.
- ***Payback Period = Initial Investment / Cash Flow Per Year***

Net Present Value

- The net present value is calculated by taking the difference between the *present value of cash inflows* and the *present value of cash outflows* over a period of time. The investment with a positive NPV will be considered. In case there are multiple projects, the project with a higher NPV is more likely to be selected.

$$NPV = \frac{R_t}{(1+i)^t}$$

t = time of the cash flow
i = discount rate
R_t = net cash flow

ACCOUNTING RATE OF RETURN

- In this technique, the total net income of the investment is divided by the initial or average investment to derive at the most profitable investment.
- ***ARR = average annual profit / average investment***

INTERNAL RATE OF RETURN (IRR)

- For NPV computation a discount rate is used. IRR is the rate at which the NPV becomes zero. The project with higher IRR is usually selected.

$$IRR = \frac{(\text{Cash flows})}{(1+r)^i} - \text{Initial Investment}$$

Where:
Cash flows= Cash flows in the time period
r = Discount rate
i = Time period

PROFITABILITY INDEX

- Profitability Index is the ratio of the present value of future cash flows of the project to the initial investment required for the project.
- ***Profitability Index = (Net Present value + Initial investment) / Initial investment***.

Thank You