CAPITAL BUDGETING

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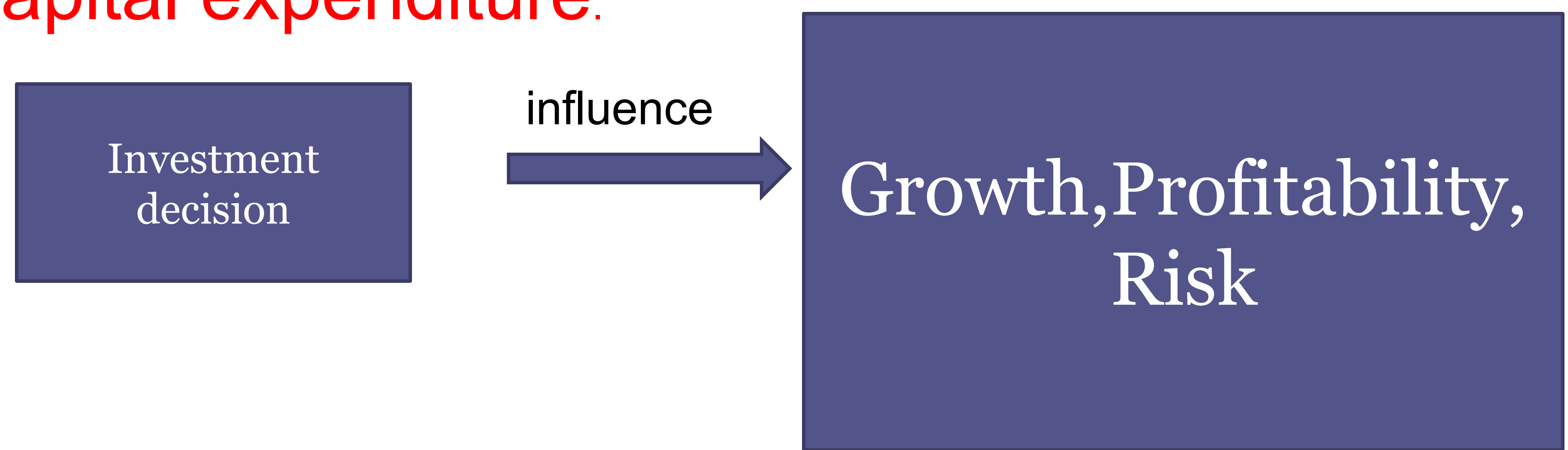
Introduction Of Capital Budgeting

An efficient allocation of capital is the most important finance function in the modern times. It involves decision to commit the firm's fund to long term asset. It is planning and control of capital expenditure.



Meaning Of Capital Budgeting

It is a process of making investment decisions in capital expenditure. It may be defined as an expenditure the benefits of which are expected to be received over a period of time.

Examples

- Cost of acquisition of permanent assets.
- Cost of addition ,expansion, alteration of an asset.
- Cost of replacement of an asset.
- Research and development of project cost.

Definition

Acc to Charles T Horn green

"Capital Budgeting is long term planning for making and financing proposal capital outlays".

Acc to Lynch

"Capital Budgeting consists in planning and development of available capital for the purpose of maximizing long term profitability of concern"

Features

- It involves exchange of current funds for the benefits to be received in the future.
- The funds are invested in long term assets.
- The future benefits will occur to the firm over a period of years.
- The funds are invested in non flexible and long term activities.
- They involve generally huge funds.
- They are irreversible decisions

Need and Importance

- Large Investments
- Long term Commitment of funds
- Irreversibility
- Long term effect on profitability
- Growth of firm
- Maximization Of Wealth

Types of Investment Decisions

- Mutually exclusive projects
- Independent or accept\reject
- Replacement projects
- Diversification projects
- Expansion Projects
- Capital Rationing Decisions

Mutually Exclusive Projects

These relate to the proposals which compete with one another in such a way that acceptance of one automatically excludes the acceptance of other.

Example = New machine | Second hand machine | Old machine on hire

Accept And Reject Or Independent Decisions

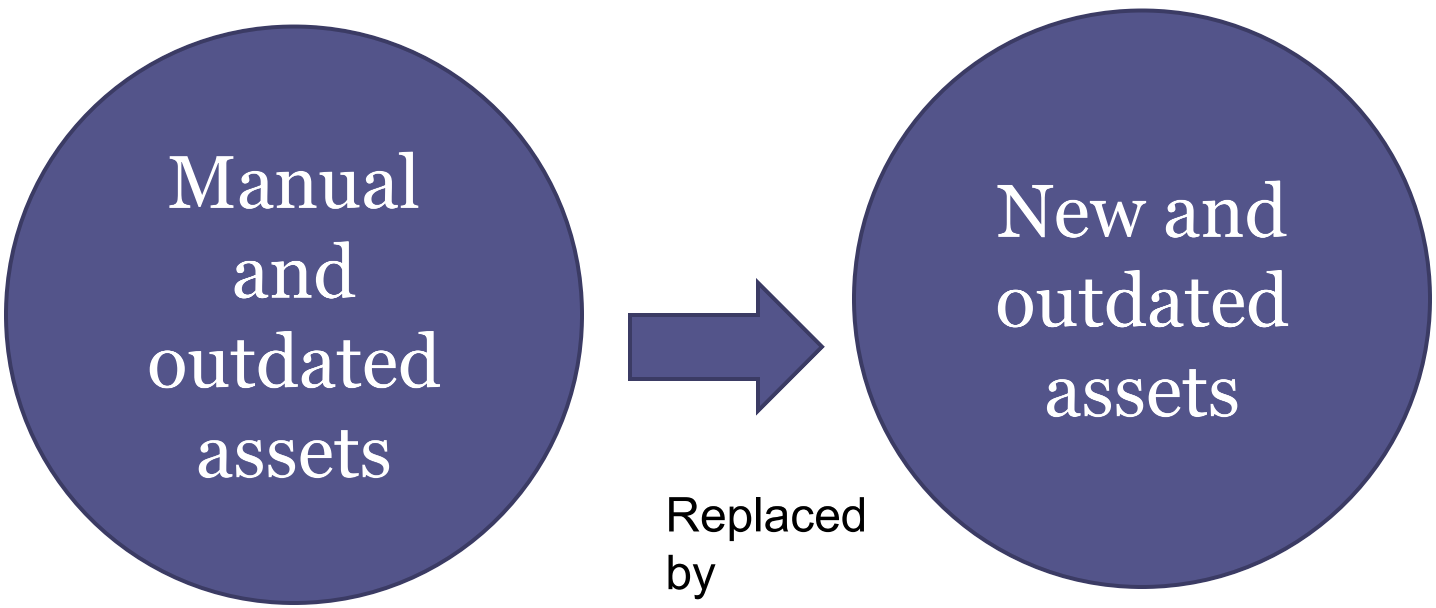
The projects under which the selection of any project does not effect the possibility of selecting another project.

Such decisions are based on the minimum return on investment. In general all those proposals which yield-

Rate of Return> Cost Of Capital (Accepted) Investment Made By the Firm

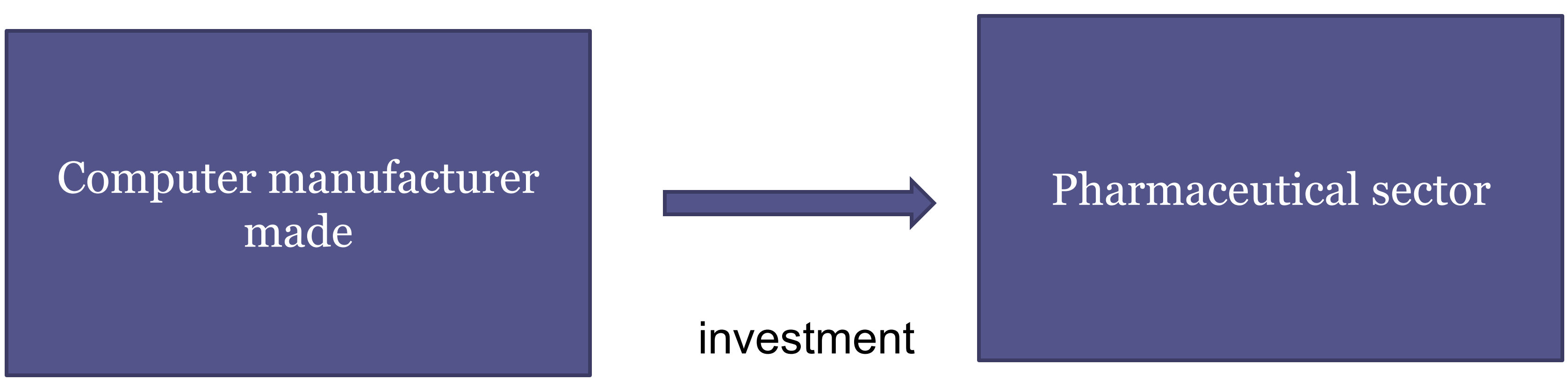
Rate of Return < Cost of Capital (Rejected) No Investment

Replacement Project decision



Diversification Projects

These are those projects where the investment is made in such a alternative which is not identical to the existing project



Expansion Projects

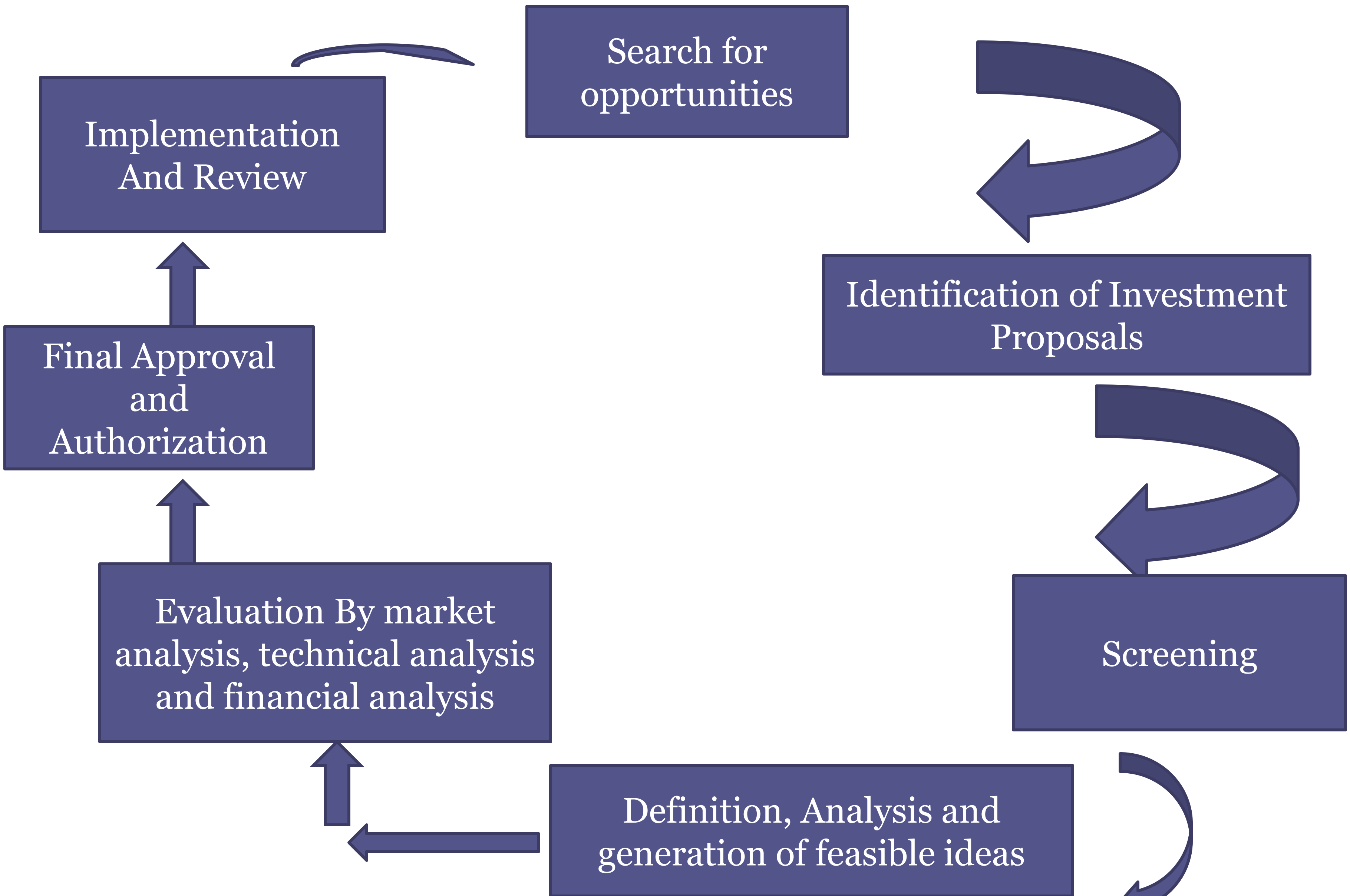
When the capacity of existing projects is expanded for increasing revenue generating capacity such projects are known as expansion projects.

Capital Rationing Decisions

A firm has several profitable investment proposals but only limited funds to invest .In such a case these proposals compete for the limited funds and thus the firm has to ration them .

A firm select a combination of proposals that will yield greatest profitability by ranking them Into descending order of their profitability

Capital Budgeting Process



Searching Of Opportunities

The capital Budgeting process begins with the identification of investment opportunities . The proposal or the idea about potential investment opportunities may originate from the top management or may come from the rank and the file worker of any department.

Identification Of Investment Proposals

The Departmental Head analyses the various proposals in light of corporate strategies and submits the report to the Capital expenditure Committees

Earlier the opportunity will be detected → Greater should be the returns before the competitors react

Screening The Alternatives

It is subjected to a preliminary screening process in order to assess whether it is technically feasible ,resources required are available or not .This information must be utilized to ascertain whether the opportunities are compatible with the existing businesses and corporate strategies.

Analysis of feasible Alternatives

If a proposal satisfied the screening process

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It is analyzed in more detail by gathering technical and economical data.

Evaluation Of The various Proposals

The next step in the capital budgeting is to evaluate the profitability of various proposals. There are many methods which may be used for this purpose likewise=

- ❖ Independent proposal
- ❖ Dependent Proposal
- ❖ Mutually Exclusive Proposal

- ❑ Payback period method
- ❑ Rate of return method
- ❑ Net present value method
- ❑ Internal Rate of return method

Fixing priorities

After evaluating various proposals ,the unprofitable or uneconomic proposals may be rejected straight way. So it might not be possible for the firm to invest in all the acceptable proposals due to limitation of funds. Hence , it is very essential to rank the proposals and to establish the priorities after considering risk and the profit.

Final Approval and Preparation Of Capital Expenditure Budget

Proposals meeting the evaluation and other criteria are finally approved to be included in the Capital Expenditure Budget. However the proposals involving the smaller investment may be decided at lower levels for the expenditure action

Implementing Proposal

It is better to assign the responsibilities for completing the project within the given time frame and cost limit so to avoid the unnecessary cost.

Network techniques used in the management like PERT and CPM can also be applied to control and monitor the implementation

Performance Review

This can be done by evaluating the performance of the project .The evaluation is made through post completion audit ;

Comparing the Actual Expenditure and return of the Project with the budgeted one

Unfavourable variances if any should be correctly rectified

And Comparing the actual return from the anticipated return

THANKS