

Capital Budgeting

Submitted By
Dr. Jaspreet Kaur

Capital Budgeting

- Capital budgeting is a company's formal process used for evaluating potential expenditures or investments that are significant in amount. It involves the decision to invest the current funds for addition, disposition, modification or replacement of fixed assets. The large expenditures include the purchase of fixed assets like land and building, new equipments, rebuilding or replacing existing equipments, research and development, etc. The large amounts spent for these types of projects are known as capital expenditures. Capital Budgeting is a tool for maximizing a company's future profits since most companies are able to manage only a limited number of large projects at any one time.
- Capital budgeting usually involves calculation of each project's future accounting profit by period, the cash flow by period, the present value of cash flows after considering time value of money, the number of years it takes for a project's cash flow to pay back the initial cash investment, an assessment of risk, and various other factors.
- **Capital is the total investment of the company and budgeting is the art of building budgets.**

FEATURES OF CAPITAL BUDGETING

- 1) It involves high risk
- 2) Large profits are estimated
- 3) Long time period between the initial investments and estimated returns

Objectives

- **1. Selecting profitable projects**
- An organization comes across various profitable projects frequently. But due to capital restrictions, an organization needs to select the right mix of profitable projects that will increase its shareholders' wealth.
- **2. Capital expenditure control**
- Selecting the most profitable investment is the main objective of capital budgeting. However, controlling capital costs is also an important objective. Forecasting capital expenditure requirements and budgeting for it, and ensuring no investment opportunities are lost is the crux of budgeting.
- **3. Finding the right sources for funds**
- Determining the quantum of funds and the sources for procuring them is another important objective of capital budgeting. Finding the balance between the cost of borrowing and returns on investment is an important goal of Capital Budgeting.

CAPITAL BUDGETING PROCESS:

- A) Project identification and generation:
 - The first step towards capital budgeting is to generate a proposal for investments. There could be various reasons for taking up investments in a business. It could be addition of a new product line or expanding the existing one. It could be a proposal to either increase the production or reduce the costs of outputs.
- B) Project Screening and Evaluation:
 - This step mainly involves selecting all correct criteria's to judge the desirability of a proposal. This has to match the objective of the firm to maximize its market value. The tool of time value of money comes handy in this step.
 - Also the estimation of the benefits and the costs needs to be done. The total cash inflow and outflow along with the uncertainties and risks associated with the proposal has to be analyzed thoroughly and appropriate provisioning has to be done for the same.

-continued

- C) Project Selection:
 - There is no such defined method for the selection of a proposal for investments as different businesses have different requirements. That is why, the approval of an investment proposal is done based on the selection criteria and screening process which is defined for every firm keeping in mind the objectives of the investment being undertaken.
 - Once the proposal has been finalized, the different alternatives for raising or acquiring funds have to be explored by the finance team. This is called preparing the capital budget. The average cost of funds has to be reduced. A detailed procedure for periodical reports and tracking the project for the lifetime needs to be streamlined in the initial phase itself. The final approvals are based on profitability, Economic constituents, viability and market conditions.
- D) Implementation:
 - Money is spent and thus proposal is implemented. The different responsibilities like implementing the proposals, completion of the project within the requisite time period and reduction of cost are allotted. The management then takes up the task of monitoring and containing the implementation of the proposals.
- E) Performance review:
 - The final stage of capital budgeting involves comparison of actual results with the standard ones. The unfavorable results are identified and removing the various difficulties of the projects helps for future selection and execution of the proposals.



FACTORS AFFECTING CAPITAL BUDGETING:

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

CAPITAL BUDGETING DECISIONS:

- **Accept / Reject decision** – If a proposal is accepted, the firm invests in it and if rejected the firm does not invest. Generally, proposals that yield a rate of return greater than a certain required rate of return or cost of capital are accepted and the others are rejected. All independent projects are accepted. Independent projects are projects that do not compete with one another in such a way that acceptance gives a fair possibility of acceptance of another.
- **Mutually exclusive project decision** – Mutually exclusive projects compete with other projects in such a way that the acceptance of one will exclude the acceptance of the other projects. Only one may be chosen. Mutually exclusive investment decisions gain importance when more than one proposal is acceptable under the accept / reject decision. The acceptance of the best alternative eliminates the other alternatives.
- **Capital rationing decision** – In a situation where the firm has unlimited funds, capital budgeting becomes a very simple process. In that, independent investment proposals yielding a return greater than some predetermined level are accepted. But actual business has a different picture. They have fixed capital budget with large number of investment proposals competing for it. Capital rationing refers to the situation where the firm has more acceptable investments requiring a greater amount of finance than that is available with the firm. Ranking of the investment project is employed on the basis of some predetermined criterion such as the rate of return. The project with highest return is ranked first and the acceptable projects are ranked thereafter.

Capital Budgeting Techniques

- **1. 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.
- **2. 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.
- **3. 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.
- **4. 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.
- **5. 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.
- Each technique comes with inherent advantages and disadvantages. An organization needs to use the best-suited technique to assist it in budgeting. It can also select different techniques and compare the results to derive at the best profitable projects.

Pay back Period Method

- *Payback period* is the time in which the [initial outlay](#) of an investment is expected to be recovered through the cash inflows generated by the investment. It is one of the simplest [investment appraisal](#) techniques.
- Since cash flow estimates are quite accurate for periods in the near future and relatively inaccurate for periods in distant future due to economic and operational uncertainties, payback period is an indicator of risk inherent in a project because it takes initial inflows into account and ignores the cash flows after the point at which the initial investment is recovered.
- Projects having larger cash inflows in the earlier periods are generally ranked higher when appraised with payback period, compared to similar projects having larger cash inflows in the later periods.

Formula

- The formula to calculate the payback period of an investment depends on whether the periodic cash inflows from the project are even or uneven.
- If the cash inflows are even (such as for investments in [annuities](#)), the formula to calculate payback period is:
$$\text{Payback Period} = \frac{\text{Initial Investment}}{\text{Net Cash Flow per Period}}$$
- When cash inflows are uneven, we need to calculate the *cumulative net cash flow* for each period and then use the following formula:
$$\text{Payback Period} = A + \frac{B}{C}$$
Where,
A is the last period number with a negative cumulative cash flow;
B is the absolute value (i.e. value without negative sign) of cumulative net cash flow at the end of the period *A*; and
C is the total cash inflow during the period following period *A*
- *Cumulative net cash flow* is the sum of inflows to date, minus the initial outflow.
- Both of the above situations are explained through examples given

Example 1: Even Cash Flows

- Company C is planning to undertake a project requiring initial investment of \$105 million. The project is expected to generate \$25 million per year in net cash flows for 7 years. Calculate the payback period of the project.
- Solution
- Payback Period
 - = Initial Investment \div Annual Cash Flow
 - = \$105M \div \$25M
 - = 4.2 years

Example 2: Uneven Cash Flows

- Company C is planning to undertake another project requiring initial investment of \$50 million and is expected to generate \$10 million net cash flow in Year 1, \$13 million in Year 2, \$16 million in year 3, \$19 million in Year 4 and \$22 million in Year 5. Calculate the payback value of the project.

Solution

Year	Annual Cash Inflow	Cumulative Cash Inflow
0	(50)	(50)
1	10	(40)
2	13	(27)
3	16	(11)
4	19	8
5	22	30

Payback Period = $3 + 11/19 = 3 + 0.58 \approx 3.6$ years

Decision Rule

- The longer the payback period of a project, the higher the risk. Between [mutually exclusive projects](#) having similar return, the decision should be to invest in the project having the shortest payback period.
- When deciding whether to invest in a project or when comparing projects having different returns, a decision based on payback period is relatively complex. The decision whether to accept or reject a project based on its payback period depends upon the risk appetite of the management.
- Management will set an acceptable payback period for individual investments based on whether the management is risk averse or risk taking. This target may be different for different projects because higher risk corresponds with higher return thus longer payback period being acceptable for profitable projects. For lower return projects, management will only accept the project if the risk is low which means payback period must be short.

Advantages of payback period are:

- Payback period is very simple to calculate.
- It can be a measure of risk inherent in a project. Since cash flows that occur later in a project's life are considered more uncertain, payback period provides an indication of how certain the project cash inflows are.
- For companies facing liquidity problems, it provides a good ranking of projects that would return money early.

Disadvantages of payback period are:

- Payback period does not take into account the time value of money which is a serious drawback since it can lead to wrong decisions. A variation of payback method that attempts to address this drawback is called discounted payback period method.
- It does not take into account, the cash flows that occur after the payback period. This means that a project having very good cash inflows but beyond its payback period may be ignored.

Accounting Rate of Return

- The accounting rate of return (ARR) is the percentage rate of return expected on investment or asset as compared to the initial investment cost. ARR divides the average revenue from an asset by the company's initial investment to derive the ratio or return that can be expected over the lifetime of the asset or related project. ARR does not consider the time value of money or cash flows, which can be an integral part of maintaining a business.
- The Formula for ARR
- *ARR = Average Annual Profit / Initial Investment*

How to Calculate the Accounting Rate of Return – ARR

- Calculate the annual net profit from the investment, which could include revenue minus any annual costs or expenses of implementing the project or investment.
- If the investment is a fixed asset such as property, plant, or equipment, subtract any depreciation expense from the annual revenue to achieve the annual net profit.
- Divide the annual net profit by the initial cost of the asset, or investment. The result of the calculation will yield a decimal. Multiply the result by 100 to show the percentage return as a whole number.

-continued

- The accounting rate of return is a [capital budgeting](#) metric useful for a quick calculation of an investment's profitability. ARR is used mainly as a general comparison between multiple projects to determine the expected rate of return from each project.
- ARR can be used when deciding on an investment or an acquisition. It factors in any possible annual expenses or [depreciation](#) expense that's associated with the project. Depreciation is an accounting process whereby the cost of a fixed asset is spread out, or expensed, annually during the useful life of the asset.
- Depreciation is a helpful accounting convention that allows companies not to have to expense the entire cost of a large purchase in year one, thus allowing the company to earn a profit from the asset right away, even in its first year of service. In the ARR calculation, depreciation expense and any annual costs must be subtracted from annual revenue to yield the net annual profit.

KEY TAKEAWAYS

- ARR is helpful in determining the annual percentage rate of return of a project.
- ARR can be used when considering multiple projects since it provides the expected rate of return from each project.
- However, ARR does not differentiate between investments that yield different cash flows over the lifetime of the project.

Example of How to Use the Accounting Rate of Return – ARR

- A project is being considered that has an initial investment of \$250,000 and it's forecasted to generate revenue for the next five years. Below are the details:
- initial investment: \$250,000
- expected revenue per year: \$70,000
- time frame: 5 years
- ARR calculation: $\$70,000$ (annual revenue) / $\$250,000$ (initial cost)
- $ARR = .28$ or 28% ($.28 * 100$)

ARR – Example 1

- XYZ Company is looking to invest in some new machinery to replace its current malfunctioning one. The new machine, which costs \$420,000, would increase annual revenue by \$200,000 and annual expenses by \$50,000. The machine is estimated to have a useful life of 12 years and zero salvage value.
- Calculate the depreciation expense per year: $\$420,000 / 12 = \$35,000$
- Calculate the average annual profit: $\$200,000 - (\$50,000 + \$35,000) = \$115,000$
- Use the formula: $ARR = \$115,000 / \$420,000 = 27.4\%$
- Therefore, this means that for every dollar invested, the investment will return a profit of about 27 cents.

ARR – Example 2

- XYZ Company is considering investing in a project that requires an initial investment of \$100,000 for some machinery. There will be net inflows of \$20,000 for the first two years, \$10,000 in years three and four, and \$30,000 in year five. Finally, the machine has a salvage value of \$25,000.

Step One: Calculate average annual profit

\$	
Inflows, Years 1 & 2($20,000 \times 2$)	40,000
Inflow, Year 3 & 4($10,000 \times 2$)	20,000
Inflow, Year 5	30,000
Less: Depreciation($100,000 - 25,000$)	(75,000)
Total Profit of Project	15,000
Average Annual Profit($15,000 / 5$)	3,000

Step Two: Calculate average investment

$$\text{Average investment} = (\$100,000 + \$25,000) / 2 = \$62,500$$

Step 3: Divide profit into cost

$$\text{ARR} = 3,000 / 62,500 = 4.8\%$$

Advantages

- Like [payback period](#), this method of investment appraisal is easy to calculate.
- It recognizes the profitability factor of investment.

Disadvantages

- It ignores time value of money. Suppose, if we use ARR to compare two projects having equal initial investments. The project which has higher annual income in the latter years of its useful life may rank higher than the one having higher annual income in the beginning years, even if the present value of the income generated by the latter project is higher.
- It can be calculated in different ways. Thus there is problem of consistency.
- It uses accounting income rather than cash flow information. Thus it is not suitable for projects which having high maintenance costs because their viability also depends upon timely cash inflows.

-continued

- ARR doesn't consider the time value of money (TVM). The time value of money is the concept that money available at the present time is worth more than an identical sum in the future due to its potential [earning capacity](#). In other words, two investments might yield uneven annual revenue streams. If one project returns more revenue in the early years and the other project returns revenue in the later years, ARR does not assign a higher value to the project that returns profits sooner, which could be reinvested to earn more money.
- The accounting rate of return does not consider the increased risk of long-term projects and the increased uncertainty associated with long periods.
- Also, ARR does not take into account the impact of cash flow timing. Let's say an investor is considering a five-year investment with an initial cash outlay of \$50,000, but the investment doesn't yield any revenue until the fourth and fifth year. The investor would need to be able to withstand the first three years without any positive cash flow from the project. The ARR calculation would not factor in the lack of cash flow in the first three years.

Net present value

- *Net present value (NPV)* of a project represents the change in a company's net worth/equity that would result from acceptance of the project over its life. It equals the [present value](#) of the project net cash inflows minus the initial investment outlay. It is one of the most reliable techniques used in capital budgeting because it is based on the [discounted cash flow](#) approach.
- Net present value calculations require the following three inputs:
- Projected net after-tax cash flows in each period of the project.
- Initial investment outlay
- Appropriate discount rate i.e. the [hurdle rate](#).

-continued

- Net after tax cash flows equals total cash inflow during a period, including salvage value if any, less cash outflows (including taxes) from the project during the period.
- The initial investment outlay represents the total cash outflow that occurs at the inception (time 0) of the project.
- The present value of net cash flows is determined at a discount rate which is reflective of the project risk. In most cases, it is appropriate to start with the weighted average cost of capital (WACC) of the company and adjust it up or down depending on the difference between the risk of the specific project and average risk of the company as a whole.

Formulas and calculation

- The first step involved in the calculation of NPV is the estimation of net cash flows from the project over its life. The second step is to discount those cash flows at the hurdle rate.
- The net cash flows may be even (i.e. equal cash flows in different periods) or uneven (i.e. different cash flows in different periods). When they are even, present value can be easily calculated by using the formula for [present value of annuity](#). However, if they are uneven, we need to calculate the present value of each individual net cash inflow separately.
- Once we have the total present value of all project cash flows, we subtract the initial investment on the project from the total present value of inflows to arrive at net present value.
- Thus we have the following two formulas for the calculation of NPV:
- *When net cash flows are even, i.e. when all net cash flows are equal:*

Decision rule

- In case of standalone projects, accept a project only if its NPV is positive, reject it if its NPV is negative and stay indifferent between accepting or rejecting if NPV is zero.
- In case of mutually exclusive projects (i.e. competing projects), accept the project with higher NPV.

Example 1: Even net cash flows

- Calculate the net present value of a project which requires an initial investment of \$243,000 and it is expected to generate a net cash flow of \$50,000 each month for 12 months. Assume that the salvage value of the project is zero. The target rate of return is 12% per annum.

Solution

- We have,
Initial Investment = \$243,000
Net Cash Inflow per Period = \$50,000
Number of Periods = 12
Discount Rate per Period = $12\% \div 12 = 1\%$
- Net Present Value
 $= \$50,000 \times (1 - (1 + 1\%)^{-12}) \div 1\% - \$243,000$
 $= \$50,000 \times (1 - 1.01^{-12}) \div 0.01 - \$243,000$
 $\approx \$50,000 \times (1 - 0.887449) \div 0.01 - \$243,000$
 $\approx \$50,000 \times 0.112551 \div 0.01 - \$243,000$
 $\approx \$50,000 \times 11.2551 - \$243,000$
 $\approx \$562,754 - \$243,000$
 $\approx \$319,754$

Example 2: Uneven net cash flows

- An initial investment of \$8,320 thousand on plant and machinery is expected to generate net cash flows of \$3,411 thousand, \$4,070 thousand, \$5,824 thousand and \$2,065 thousand at the end of first, second, third and fourth year respectively. At the end of the fourth year, the machinery will be sold for \$900 thousand. Calculate the net present value of the investment if the discount rate is 18%. Round your answer to nearest thousand dollars.

Solution

- PV Factors:

Year 1 = $1 \div (1 + 18\%)^1 \approx 0.8475$

Year 2 = $1 \div (1 + 18\%)^2 \approx 0.7182$

Year 3 = $1 \div (1 + 18\%)^3 \approx 0.6086$

Year 4 = $1 \div (1 + 18\%)^4 \approx 0.5158$

• Year	1	2	3	4
• Net Cash Inflow	\$3,411	\$4,070	\$5,824	\$2,065
• Salvage Value				900
• Total Cash Inflow	\$3,411	\$4,070	\$5,824	\$2,965
• × Present Value Factor	0.8475	0.7182	0.6086	0.5158
• Present Value of Cash Flows	\$2,890.68	\$2,923.01	\$3,544.67	\$1,529.31
• Total PV of Cash Inflows	\$10,888			
• – Initial Investment	– 8,320			
• Net Present Value	\$2,568 thousand			

Strengths

- Net present value accounts for time value of money which makes it a better approach than those investment appraisal techniques which do not discount future cash flows such as payback period and accounting rate of return.
- Net present value is even better than some other discounted cash flow techniques such as IRR. In situations where IRR and NPV give conflicting decisions, NPV decision should be preferred.

Weaknesses

- NPV is after all an estimation. It is sensitive to changes in estimates for future cash flows, salvage value and the cost of capital. NPV analysis is commonly coupled with [sensitivity analysis](#) and [scenario analysis](#) to see how the conclusion changes when there is a change in inputs.
- Net present value does not take into account the size of the project. For example, say Project A requires initial investment of \$4 million to generate NPV of \$1 million while a competing Project B requires \$2 million investment to generate an NPV of \$0.8 million. If we base our decision on NPV alone, we will prefer Project A because it has higher NPV, but Project B has generated more shareholders' wealth per dollar of initial investment ($\$0.8 \text{ million} / \2 million vs $\$1 \text{ million} / \4 million).

Internal rate of return

- The Internal Rate of Return (IRR) is the discount rate that makes the net present value (NPV) of a project zero. In other words, it is the expected compound annual rate of return that will be earned on a project or investment. In the example below, an initial investment of \$50 has a 22% IRR. That is economically equal to earning a 22% compound annual growth rate.

-continued

- When calculating IRR, expected cash flows for a project or investment are given and the NPV equals zero. Put another way, the initial cash investment for the beginning period will be equal to the present value of the *future* [cash flows](#) of that investment. (Cost paid = present value of future cash flows, and hence, the *net* present value = 0).
- Once the internal rate of return is determined, it is typically compared to a company's [hurdle rate](#) or cost of capital. If the IRR is greater than or equal to the cost of capital, the company would accept the project as a good investment. (That is, of course, assuming this is the sole basis for the decision. In reality there are many other quantitative and qualitative factors that are considered in an investment decision.) If the IRR is lower than the hurdle rate, then it would be rejected.

$$0 = CF_0 + \frac{CF_1}{(1 + IRR)} + \frac{CF_2}{(1 + IRR)^2} + \frac{CF_3}{(1 + IRR)^3} + \dots + \frac{CF_n}{(1 + IRR)^n}$$

Or

$$0 = NPV = \sum_{n=0}^N \frac{CF_n}{(1 + IRR)^n}$$

Where:

CF_0 = Initial Investment / Outlay

$CF_1, CF_2, CF_3 \dots CF_n$ = Cash flows

n = Each Period

N = Holding Period

NPV = Net Present Value

IRR = Internal Rate of Return

Profitability Index

- The profitability index rule is a decision-making exercise that helps evaluate whether to proceed with a project. The index itself is a calculation of the potential profit of the proposed project. The rule is that a profitability index or ratio greater than 1 indicates that the project should proceed. A profitability index or ratio below 1 indicates that the project should be abandoned.
- KEY TAKEAWAYS
- The formula for PI is initial project cost divided by present value of future cash flows.
- The PI rule is that a result above 1 indicates a go, while a result under 1 is a loser.
- The PI rule is a variation of the NPV rule.

Present Value of Future Cash Flows

Profitability Index =

Initial investment

Limitations of Capital Budgeting

- 1. The economic life of the project and annual cash inflows are only an estimation. The actual economic life of the project is either increased or decreased. Likewise, the actual annual cash inflows may be either more or less than the estimation. Hence, [control over capital expenditure](#) can not be exercised.
- 2. The application of capital budgeting technique is based on the presumed cash inflows and cash outflows. Since the future is uncertain, the presumed cash inflows and cash outflows may not be true. Therefore, the selection of profitable project may be wrong.
- 3. Capital budgeting process does not take into consideration of various non-financial aspects of the projects while they play an important role in successful and profitable implementation of them. Hence, true profitability of the project cannot be highlighted.
- 4. It is also not correct to assume that mathematically exact techniques always produce highly accurate results.

-continued

- 5. All the techniques of capital budgeting presume that various investment proposals under consideration are mutually exclusive which may not be practically true in some particular circumstances.
- 6. The [morale of the employee](#), goodwill of the company etc. cannot be quantified accurately. Hence, these can substantially influence capital budgeting decision.
- 7. Risk of any project cannot be presumed accurately. The project risk is varying according to the changes made in the business world.
- 8. In case of urgency, the capital budgeting technique cannot be applied.
- 9. Only known factors are considered while applying capital budgeting decisions. There are so many unknown factors which are also affecting capital budgeting decisions. The unknown factors cannot be avoided or controlled.

Rationale of capital budgeting decisions

- **1. Investment decisions affecting revenue**
- It includes all those investment decisions which are expected to bring additional revenue by raising the size of firm's total revenue. It is possible either by expansion of present operations or the development of new product in line. In both the cases fixed assets are required.
- **2. Investment decisions reducing costs**
- It includes all those decisions of the firms which reduces the total cost and leads to increase in its total earnings i.e. when an asset is worn out or becomes outdated, the firm has to decide whether to continue with it or replace it by new machine. For this, the firm evaluates the benefit in the form of reduction in operating costs and outlays that would be needed to replace old machine by new one. A firm will replace an asset only when it finds it beneficial to do so. The above decision could be followed decisions following alternative courses: i.e., **Tactical investment decisions to strategic investment decisions,**

-continued

- **Tactical investment decisions**
- It includes those **investment decisions** which generally involves a small amount of funds and does not constitute a major departure from what the firm has been doing in the past.
- **Strategic investment decisions**
- Such decisions involve large sum of money and envisage major departure from what the company has been doing in the past. Acceptance of strategic investment will involve significant change in the company's expected profits and the risk to which these profits will be subject. These changes are likely to lead stock-holders and creditors to revise their evaluation of the company.

Significance of Capital Budgeting

- **(a) Long-term Applications:** Implies that capital budgeting decisions are helpful for an organization in the long run as these decisions have a direct impact on the cost structure and future prospects of the organization. In addition, these decisions affect the organization's growth rate. Therefore, an organization needs to be careful while making capital decisions as any wrong decision can prove to be fatal for the organization. For example, over-investment in various assets can cause shortage of capital to the organization, whereas insufficient investments may hamper the growth of the organization.
- **(b) Competitive Position of an Organization:** Refers to the fact that an organization can plan its investment in various fixed assets through capital budgeting. In addition, capital investment decisions help the organization to determine its profits in future. All these decisions of the organization have a major impact on the competitive position of an organization.
- **(c) Cash Forecasting:** Implies that an organization needs a large amount of funds for its investment decisions. With the help of capital budgeting, an organization is aware of the required amount of cash, thus, ensures the availability of cash at the right time. This further helps the organization to achieve its long-term goals without any difficulty.
- **(d) Maximization of Wealth:** Refers to the fact that the long-term investment decisions of an organization helps in safeguarding the interest of shareholders in the organization. If an organization has invested in a planned manner, shareholders would also be keen to invest in the organization. This helps in maximizing the wealth of the organization. Capital budgeting helps an organization in many ways. Thus, an organization needs to take into consideration various aspects.

Conclusion

- Capital budgeting is a predominant function of management. Right decisions taken can lead the business to great heights. However, a single wrong decision can inch the business closer to shut down due to the number of funds involved and the tenure of these projects.