**CAPITAL BUDGETING**

**INTRODUCTION**

Capital budgeting is the finance process involved in assessing the viability of independent or mutually exclusive investment or expansion projects or firms. It is also referred to as investment appraisal. It employs various methods and techniques to assess whether single or independent projects or two or more dependent or mutually exclusive projects should be undertaken.

**ANALYSIS OF CAPITAL BUDGETING TECHNIQUES**

Capital budgeting techniques or investment appraisal methods are categorized into two groups.

1. Discounted methods. These are the techniques which are based on the interest rate of return or discount rate used to discount the project or investment cash inflows and outflows. They include the net present value method (NPV), project internal rate of return, profitability index and discounted payback period which discount project cash flows in appraising of investment projects. Discounting cash flows is finding their present value by dividing the cash flow with the discount factor, (1- r) n where r is the rate of interest ie 0.1 if interest rate is 10% and n is the period of the cash flow ie time period 0, 1, 2, …, up to period “n”.
2. Non discounted methods. These are techniques which calculate the viability of the investment project without recognizing the effect of increase in cash flows due to existence of an interest rate or discount rate. They include methods like payback period and accounting rate of return.

**DECISION CRITERIA**

Each investment appraisal techniques applies a certain decision criterion to help decide whether a project should be undertaken independently on its own or over other mutually exclusive project. For example, in NPV method the project should be undertaken if its total discounted cash flows minus initial investment or its Net present value is positive and if it exceeds the NPV of other projects. In payback period method the project which pays initial investment fastest is undertaken.