Capital Budgeting and Investment Appraisal

Capital Budgeting

Developing financial plans for long-term investments and determining whether the investments will be valuable.

Estimating Project Cash Flows

There are several classes of cash flows to consider: - Investments - Cash outlays required to setup the needed infrastructure. - Interim Cash flows - Operating cash flows - Terminal cash flows - Exit cash flows at he end of the project's useful life.

There are basic characteristics of relevant cash flows: - Cash (not accounting income) flows - Operating (not financing) flows - After-tax flows - Incremental flows

Operating Cash Flows The basic principles for estimating operating cash flows are: - Ignore sunk costs - Include opportunity costs - Include project-driven changes in net working capital - Include effects of inflation

> Sunk Cost - An unrecoverable past cost that cannot be recovered and so should not affect present actions or future decisions.

> Opportunity Cost - A benefit forgone by choosing one alternative over another.

> Opportunity costs are relevant costs while sunk costs are not.

Tax Considerations

- Timing of payment of taxes
- Capital Allowances available
- Timing of claim for capital allowances

Timing of Tax payment

- Tax is payable in arrears, i.e. tax for year 1 is payable at the end of year 2.
- Tax is paid in the same year as the profit arises for accounting purposes.

Timing of Capital Allowances

- First claim occurs at the start of the project.
- First claim occurs later in the first year.

Dealing with Tax-Allowable Depreciation / Capital Allowances