Capital Budgeting

Capital budgeting involves choosing projects that add value to a company. The capital budgeting process can involve almost anything including acquiring land or purchasing fixed assets like a new truck or machinery. Corporations are typically required, or at least recommended, to undertake those projects which will increase profitability and thus enhance shareholders' wealth. However, what rate of return is deemed acceptable or unacceptable is influenced by other factors that are specific to the company as well as the project. For example, a social or charitable project is often not approved based on the rate of return, but more on the desire of a business to foster goodwill and contribute back to its community.

Capital budgeting is important because it creates accountability and measurability. Any business that seeks to invest its resources in a project, without understanding the risks and returns involved, would be held as irresponsible by its owners or shareholders. Furthermore, if a business has no way of measuring the effectiveness of its investment decisions, chances are that the business will have little chance of surviving in the competitive marketplace.

Businesses (aside from non-profits) exist to earn profits. The capital budgeting process is a measurable way for businesses to determine the long-term economic and financial profitability of any investment project.

How Capital Budgeting Works

When a firm is presented with a capital budgeting decision, one of its first tasks is to determine whether or not the project will prove to be profitable. The payback period (PB), internal rate of return (IRR) and net present value (NPV) methods are the most common approaches to project selection. Although an ideal capital budgeting solution is such that all three metrics will indicate the same decision, these approaches will often produce contradictory results. Depending on management's preferences and selection criteria, more emphasis will be put on one approach over another. Nonetheless, there are common advantages and disadvantage associated with these widely used valuation methods.

Features of Capital Budgeting

The features of capital budgeting are briefly explained below:

1. Capital budgeting involves the investment of funds currently for getting benefits in the future.
2. Generally, the future benefits are spread over several years.
3. The long term investment is fixed.
4. The investments made in the project are determining the financial condition of business organization in future.
5. Each project involves huge amount of funds.
6. Capital expenditure decisions are irreversible.
7. The profitability of the business concern is based on the quantum of investments made in the project.

Importance of Capital Budgeting

For the growth & prosperity of the business, long-term goals are very important for any organization. A wrong decision can be disastrous for the long-term survival of the firm. Capital budgeting has its effect in a long time span. It also affects companies future cost & growth.

1. Involvement of a large number of funds-

Capital Investment requires a large number of funds. As the companies have limited resources, the company has to make a wise & correct investment decision. The wrong decision would harm the sustainability of the business. The large investment includes the purchase of an asset, rebuilding or replacing existing equipment.

2. Irreversible decision-

The capital Investment decisions are generally irreversible as it requires large amounts of funds. It is difficult to find the market for that asset. The only way remains with the company is to scrap the asset & incur heavy losses.

3. Monitoring & controlling the expenditure-

Capital budget carefully identifies the necessary expenditure and R&D required for an investment project. Since a good project can turn bad if expenditures aren't carefully controlled or monitored, this step is a crucial benefit of the capital budgeting process.

4. Transfer of information-

The time that project starts off as an idea, it is accepted or rejected; numerous decisions have to be made at a various level of authority. The capital budgeting process facilitates the transfer of information to appropriate decision makers within a company.

5. Difficulties of investment decision-

The long-term investment decisions are difficult because it extends several years beyond the current period. Uncertainty indicates a higher degree of risk. Management loses his flexibility and liquidity of funds in making investment decisions so it must consider each proposal very thoroughly.

6. Maximization of wealth-

Long-term investment decision of the organization helps in safeguarding the interest of the shareholder in the organization. If the organization has invested in a planned manner, the shareholder would also be keen to invest in that organization. This helps in the maximization of wealth of the organization. Any expansion is fundamentally related to further sales and future profitability of the firm and assets acquisition decisions are based on capital budgeting.

Objectives of Capital Budgeting

- **Selection of Profitable Project-**

The capital budgeting has a significant long term effect. Usually an organization encounters several profitable projects. But the organization chooses a balanced project to increase the share holder.

- **Controlling the Expenditure-**

The primary objective of the project is to selecting the most profitable project. The technique also helps to controls the expenditure of the project. The most significant objective of the capital budgeting is to predicting the expense on a project as per the requirement and then budgeting for it. Then the process makes sure that the opportunity does not lose the track and no wastage of money happens.

- **Finding the Right Resources -**

Finding the right resource for funds happen only after the calculation of the right amount of the money. You need to find the balance of the expenditure and the cost before borrowing money from the resources. Before borrowing money you need to think the return on investment. It is another objective of capital budgeting.