CAPITAL BUDGETING

Meaning

Capital budget involves the planning to acquire worthwhile projects, together with the timings of the estimated cost and cash flow of each project. Such projects require large sum of funds and have long-term implications for the firm. Capital budgets are difficult to prepare because estimates of the cash flows over a long period have to be made which involve a great degree of uncertainty. The term capital budget can be applied to budgets that lay down the estimates in respect of the capital resources of the firm. The operating budget helps to prepare the estimated income statement. The capital budgets facilitate in the task of compiling of a projected balance sheet. The capital budgets can be prepared for long-term as well as for the short-term capital. The capital budgets specify the capital intentions of the management and as such often reflect the management policy in respect of investment, expansion, growth, contraction, production and profits. **Capital budgeting includes both raising of long term funds as well as their utilization. It may be defined as, "The firm's formal process for acquisition and investment of capital." It involves firm's decision to invest its current funds for addition, deposition, modification and replacement of long-term or fixed assets.** Capital budgeting is a many sided activity. lt includes searching for new and more profitable investment proposals, investigating engineering and marketing considerations to predict the consequences of accepting the investment and making economic analysis to determine the profit potential of each investment proposal. Its basic features can be summarized as under:

- It has the potentiality of making large anticipated profits.
- It involves a high degree of risk.
- It involves a relatively long-time period between the initial outlay and the anticipated return.

Capital budgeting is made up of two words ‘capital’ and ‘budgeting.’ In this context, capital expenditure is the spending of funds for large expenditures like purchasing fixed assets and equipment, repairs to fixed assets or equipment, research and development, expansion and the like. Budgeting is setting targets for projects to ensure maximum profitability.

Definition

1) “Capital budgeting is a long term planning for making and financing proposed capital outlay” **- Charles T. Horngreen.**

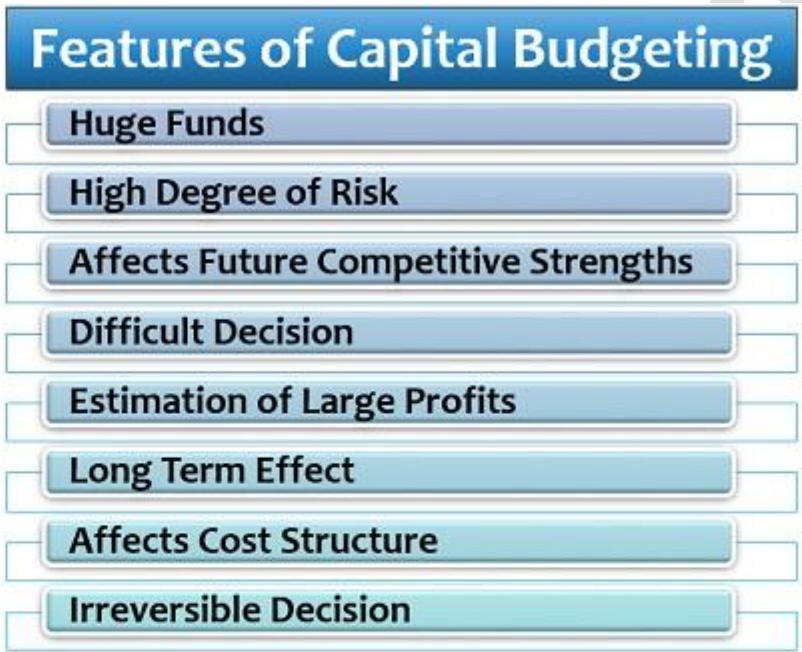
2) “Capital Budgeting refers to the total process of generating, evaluating, selecting and following up on capital expenditure alternatives” - **Gitman L. J.**

3) "Capital Budgeting consists in planning for development of available capital for the purpose of maximizing the long-term profitability (return on investment) of the firm" - **R. M. Lynch**.

Thus capital budgeting is concerned with designing and carrying out a systematic investment programme which would provide yields over number of years.

Need / Features of Capital Budgeting

Capital budgeting is a crucial decision and to understand the concept in a better way, let us go through its following features:



- **Huge Funds:** Capital budgeting involves expenditures of high value which makes it a crucial function for the management.

- **High Degree of Risk:** To take decisions which involve huge financial burden can be risky for the company.

- **Affects Future Competitive Strengths:** The Company's future is based on such capital expenditure decisions. Sensible investing can improve its competitiveness, whereas a wrong investment may lead to business failure.

- **Difficult Decision:** When the future is dependent on capital budgeting decisions, it becomes difficult for the management to grab the most appropriate investment opportunity.

- **Estimation of Large Profits:** Any investment decision taken by the company is made with the perspective of earning desirable profits in the long term.

- **Long Term Effect:** The effect of the decisions taken today, whether favorable or unfavorable, will be visible in the future or the long term.

- **Affects Cost Structure:** The company's cost structure changes with the capital budgeting; for instance, it may increase the fixed cost such as insurance charges, interest, depreciation, rent, etc.

- **Irreversible Decision:** A decision once taken is tough to be amended since it involves a high-value asset which may not be sold at the same price once purchased.

Factors Affecting Capital Budgeting

The capital budgeting decisions influenced by various elements present in the internal and external business environment. Following are some of the significant factors affecting investment decisions:

- **Capital Structure:** The Company's capital structure, i.e., the composition of shareholder's funds and borrowed funds, determines its capital budgeting decisions.

- **Working Capital:** The availability of capital required by the company to carry out day to day business operations influences its long-term decisions.

- **Capital Return:** The management estimates the expected return from the prospective capital investment while planning the company's capital budget.

- **Availability of Funds:** The company's potential for capital budgeting is dependent on its dividend policy, availability of funds and the ability to acquire funds from the other sources.

- **Earnings:** If the company has a stable earning, it may plan for massive investment projects on leveraged funds, but the same is not suitable in case of irregular earnings.

- **Lending Policies of Financial Institutions:** The terms on which financial institutions provide loans such as interest rates, collateral, duration, etc. contributes to capital budgeting decisions.

- **Management Decisions:** The decision of the management to take a risk and invest funds in high-value assets or holding some other plan, also determines the capital budgeting of the company.

- **Project Needs:** The Company needs to consider all the essentials of a new project. Also, the means to fulfill the requirements along with the estimate of the related expenses should be clear.

➢ **Accounting Methods:** The accounting rules, principles and methods of the company are another factor considered while capital budgeting to frame the reporting of such expenses and revenue to be generated in future.

➢ **Government Policy:** The restrictions imposed and the exemptions allowed by the government to the companies while investing in capital nature, impacts the company's capital budgeting decisions.

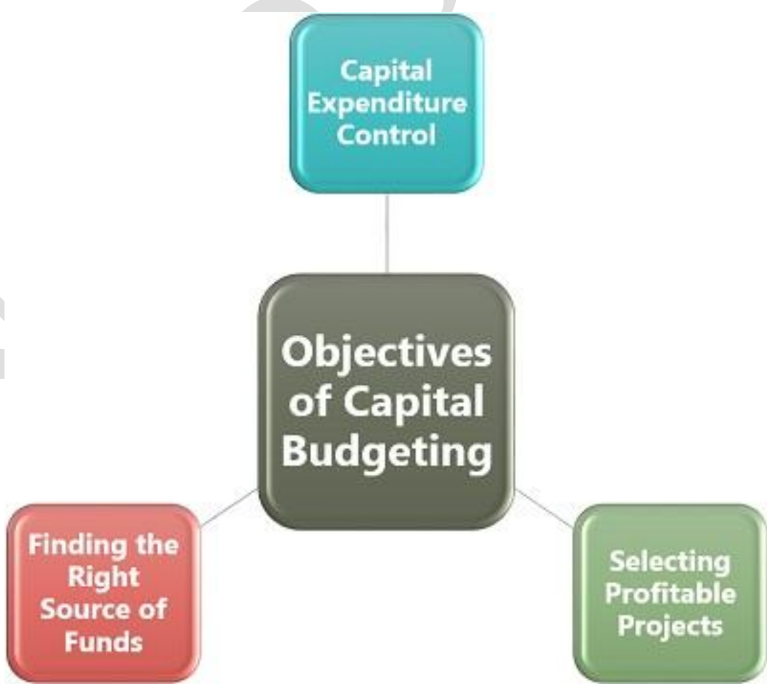
➢ **Taxation Policy:** The taxation procedure and policy of the country also influences the long-term investment decision of the firm since additional capital will be required for such expenses.

➢ **Project's Economic Value:** The total cost estimated for the long-term investment and the capacity of the company determines the capital budgeting decisions.

Objectives of Capital Budgeting

What is the need for capital budgeting? Why do companies invest so much time and efforts in it? Capital budgeting is the long-term decision which affects the business to a great extent.

To know more about the necessity of capital budgeting for the companies, let us go through the following objectives:



- **Control of Capital Expenditure:** Estimating the cost of investment provides a base to the management for controlling and managing the required capital expenditure accordingly.

- **Selection of Profitable Projects:** The Company has to select the most suitable project out of the multiple options available to it. For this, it has to keep in mind the various factors such as availability of funds, project's profitability, the rate of return, etc.

- **Identifying the Right Source of Funds:** Locating and selecting the most appropriate source of fund required to make a long-term capital investment is the ultimate aim of capital budgeting. The management needs to consider and compare the cost borrowing with the expected return on investment for this purpose.

Capital Budgeting Decisions

The organization's all capital budgeting decisions can be broadly categorized under the following three types:

1. **Accept / Reject Decision:** This type of arrangement is fundamental and mostly applies to the independent projects which are not affected by the acceptance possibility of other projects. The projects which generate a high rate of return or cost of capital are accepted, and the plans which do not fulfill the criteria are rejected.

2. **Mutually Exclusive Project Decision:** These projects compete with one another, i.e., the possibility of accepting one project excludes the acceptance of the other.

3. **Capital Rationing Decision:** The term itself explains that the limitation of capital dominates such decisions. In a situation where the firm has multiple investment options demanding huge funds, the management ranks the projects on specific criteria; such as the rate of return of each project. Then, the projects with the highest percentage of profit or those which fulfill the requirements most can be selected.

Limitations of Capital Budgeting

1. The economic life of the project and annual cash inflows are only 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 cannot 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.

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.