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Assignment - 2

3) Methods of capital Budgetting.

* Capital budgeting is the process companies use to evaluate and select major long-term investments, such as building a new factory, launching a new product (or upgrading machinery.

(A) Traditional (Non- Discounting) Methods

These methods are simple but less accurate because they ignore the time value of money.

* Pay back Period (PBP):

* what it is : calculates the time (in years) it takes for a project's cash inflows to equal the intial Investment cost.

Pros:- very simple, easy to understand, and highlights liquidity and risk (a faster payback is less risky).

Cons:- Its main flaw is that it Completely ignores any cash flows after the payback period and ignores the time value of money within the period.

B) Modern (Discounted cashflow - DCF) methods

* These methods are superior because they incorporate the time value of money and risk.

Net Present value (NPV)

* What it is :- Considered the best method. It calculates the present value of all future cash inflows and subtracts the present value of the cash outflows.

Decision rule :-

NPV > 0 : Accept the project. It creates value for the firm.

NPV < 0 : Reject the project. It destroys value.

Pros :- Provides a clear dollar amount of value added and is theoretically the most sound method.

4) Factors Affecting Working capital Requirements.

* working capital is the cash a business has tied up in its day-to-day operations to run smoothly. It is the difference b/w short-term assets and short-term liabilities.

Net Working Capital = current Assets - current Liabilities.

The amount of working capital a firm needs depends on several factors -

1) Nature of Business

* Manufacturing / Retail Firms:

Need high working capital, They must invest heavily in raw materials, work-in-progress and finished goods inventory.

2) Length of the operating cycle

* A longer cycle means cash is tied up for longer, required more working capital. A shorter cycle, require less.

3) Credit Policy

* Credit to customers (Receivables):

A liberal policy means the firm has to wait longer for its cash, increasing its working capital needs.

4) Business Growth

* Rapidly growing companies need a growing amount of working capital. Every new ~~gate~~ sale requires more inventory and creates more accounts receivable, consuming cash. This is why some fast-growing, profitable companies can actually run out of cash.

5) Inflation

* When prices rise, a company must spend more money to buy the same quantity of raw materials or labor. This inflates the values of inventory and receivables, requiring more cash to run the business.