Capital Budgeting

Meaning of Capital Budgeting:

Capital expenditure budget or capital budgeting is a process of making decisions regarding investments in fixed assets or capital assets such as land, building, machinery or furniture. Normally capital expenditure is one which is intended to benefit in the future period of time i.e. more than one year.

Capital budgeting is the planning process used to determine whether an organization's long term investments such as purchase of new machinery, replacement of old machinery, Purchase of new plants, Introduction of new products, and research development projects are worth pursuing. It is a budget for major capital expenditures.

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The word 'investment' refers to the expenditure which is required to be made in connection with the acquisition and the development of long-term or fixed assets. It refers to process by which management selects those investment proposals which are worthwhile for investing available funds. For this purpose, management is to decide whether or not to acquire, or add to or replace fixed assets in the light of overall objectives of the firm.

Capital budgeting is an extremely important aspect of a company's financial management. If a company makes a mistake in its capital budgeting process, then it has to live with that mistake for a long period of time as it cannot be reversed.

Nature of Capital Budgeting

Nature of capital budgeting can be explained in brief as under Capital expenditure plans involve a huge investment in fixed assets. Capital expenditure once approved represents long-term investment that cannot be reserved or withdrawn without sustaining a loss. Preparation of coital budget plans involve forecasting of several years profits in advance in order to judge the profitability of projects. It may be asserted here that decision regarding capital investment should be taken very carefully so that the future plans of the company are not affected adversely.

Importance/Need of Capital Budgeting

Capital budgeting decisions are of paramount importance in financial decision. So it needs special care on account of the following reasons:

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1) Long-term Implications:

A capital budgeting decision has its effect over a long time span and inevitably affects the company's future cost structure and growth. A wrong decision can prove disastrous for the long-term survival of firm. On the other hand, lack of investment in asset would influence the competitive position of the firm. So the capital budgeting decisions determine the future destiny of the company.

2) **Involvement of large amount of funds:**

Capital budgeting decisions need substantial amount of capital outlay. This underlines the need for thoughtful, wise and correct decisions as an incorrect decision would not only result in losses but also prevent the firm from earning profit from other investments which could not be undertaken.

3) **Irreversible decisions:**

Capital budgeting decisions in most of the cases are irreversible because it is difficult to find a market for such assets. The only way out will be scrap the capital assets so acquired and incur heavy losses.

4) **Risk and uncertainty:**

Capital budgeting decision is surrounded by great number of uncertainties. Investment is present and investment is future. The future is uncertain and full of risks. Longer the period of project, greater may be the risk and uncertainty. The estimates about cost, revenues and profits may not come true.

5) **Difficult to make:**

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Capital budgeting decision making is a difficult and complicated exercise for the management. These decisions require an over all assessment of future events which are uncertain. It is really a marathon job to estimate the future benefits and cost correctly in quantitative terms subject to the uncertainties caused by economic-political social and technological factors.
Kinds of capital budgeting decisions:
Generally the business firms are confronted with three types of capital budgeting decisions.

Accept-Reject Decisions;

I. Mutually Exclusive Decisions; and (iii) Capital Rationing Decisions.
II. Accept-Reject Decisions: Business firm is confronted with alternative investment proposals. If the proposal is accepted, the firm incur the investment and not otherwise. Broadly, all those investment proposals which yield a rate of return greater than cost of capital are accepted and

the others are rejected. Under this criterion, all the independent proposals are accepted.

III. Mutually Exclusive Decisions: It includes all those projects which compete with each other in a way that acceptance of one precludes the acceptance of other or others. Thus, some technique has to be used for selecting the best among all and eliminates other alternatives.

IV. Capital Rationing Decisions: Capital budgeting decision is a simple process in those firms where fund is not the constraint, but in majority of the cases, firms have fixed capital budget. So, large amount of projects compete for these limited budgets. So the firm rations them in a manner so as to maximize the long run returns. Thus, capital rationing refers to the situations where the firm has more acceptable investment requiring greater amount of finance than is available with the firm. It is concerned with the selection of a group of investment out of many investment proposals ranked in the descending order of the rate or return.

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Procedure of Capital Budgeting

Capital investment decision of the firm have a pervasive influence on the entire spectrum of entrepreneurial activities so the careful consideration should be regarded to all aspects of financial management.

In capital budgeting process, main points to be borne in mind how much money will be needed of implementing immediate plans, how much money is available for its completion and how are the available funds going to be assigned tote various capital projects under consideration. The financial policy and risk policy of the management should be clear in mind before proceeding to the capital budgeting process. The following procedure may be adopted in preparing capital budget:

(1) **Organisation of Investment Proposal**

The first step in capital budgeting process is the conception of a profit making idea. The proposals may come from rank and file worker of any department or from any line officer. The department head collects all the investment proposals and reviews them in the light of financial and risk policies of the organisation in order to send them to the capital expenditure planning committee for consideration.

(2) **Screening the Proposals**

In large organisations, a capital expenditure planning committee is established for the screening of various proposals received by it from the heads of various departments and the line officers of the company. The committee screens the various proposals within the long-range policy-frame work of the organisation. It is to be ascertained by the committee whether the proposals are within the selection criterion of the firm, or they do no lead to department imbalances or they are profitable

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(3) **Evaluation of Projects**

The next step in capital budgeting process is to evaluate the different proposals in term of the cost of capital, the expected returns from alternative investment opportunities and the life of the assets with any of the following evaluation techniques:

- Pay-Back Period Method
- Accounting Rate of return Method
- Net Present Value Method
- Profitability-Index Method

- Internal Rate of Return Method

(4) **Establishing Priorities**

After proper screening of the proposals, uneconomic or unprofitable proposals are dropped. The profitable projects or in other words accepted projects are then put in priority. It facilitates their acquisition or construction according to the sources available and avoids unnecessary and costly delays and serious cotoverruns. Generally, priority is fixed in the following order.

· Current and incomplete projects are given first priority.
· Safety projects ad projects necessary to carry on the legislative requirements.
· Projects of maintaining the present efficiency of the firm.
· Projects for supplementing the income.
· Projects for the expansion of new product.

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(5) **Final Approval**

Proposals finally recommended by the committee are sent to the top management along with the detailed report, both o the capital expenditure and of sources of funds to meet them. The management affirms its final seal to proposals taking in view the urgency, profitability of the projects and the available financial resources. Projects are then sent to the budget committee for incorporating them in the capital budget

(6) **Evaluation**

Last but not the least important step in the capital budgeting process is an evaluation of the programme after it has been fully implemented. Budget proposals and the net investment in the projects are compared periodically and

on the basis of such evaluation, the budget figures may be reviewer and presented in a more realistic way.

Significance of capital budgeting

The key function of the financial management is the selection of the most profitable assortment of capital investment and it is the most important area of decision-making of the financial manger because any action taken by the manger in this area affects the working and the profitability of the firm for many years to come. The need of capital budgeting can be emphasized taking into consideration the very nature of the capital expenditure such as heavy investment in capital projects, long-term implications for the firm, irreversible decisions and complicates of the decision making. Its importance can be illustrated well on the following other grounds:

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(1) **Indirect Forecast of Sales**

The investment in fixed assets is related to future sales of the firm during the life time of the assets purchased. It shows the possibility of expanding the production facilities to cover additional sales shown in the sales budget. Any failure to make the sales forecast accurately would result in over investment or under investment in fixed assets and any erroneous forecast of asset needs may lead the firm to serious economic results

(2) **Comparative Study of Alternative Projects**

Capital budgeting makes a comparative study of the alternative projects for the replacement of assets which are wearing out or are in danger of becoming obsolete so as to make the best possible investment in the replacement of assets. For this purpose, the profitability of each project is estimated.

(3) **Timing of Assets-Acquisition**

Proper capital budgeting leads to proper timing of assets-acquisition and improvement in quality of assets purchased. It is due to ht nature of demand and supply of capital goods. The demand of capital goods does not arise until sales impinge on productive capacity and such situation occurs only intermittently. On the other hand, supply of capital goods with their availability is one of the functions of capital budgeting.

(4) **Cash Forecast**

Capital investment requires substantial funds which can only be arranged by making determined efforts to ensure their availability at the right time. Thus it facilitates cash forecast.

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(5) **Worth-Maximization of Shareholders**

The impact of long-term capital investment decisions is far reaching. It protects the interests of the shareholders and of the enterprise because it avoids over-investment and under-investment in fixed assets. By selecting the most profitable projects, the management facilitates the wealth maximization of equity share-holders.

(6) **Other Factors**

The following other factors can also be considered for its significance:

- It assists in formulating a sound depreciation and assets replacement policy.
- It may be useful n considering methods of coast reduction.

- A reduction campaign may necessitate the consideration of purchasing most up-to—date and modern equipment.
- The feasibility of replacing manual work by machinery may be seen from the capital forecast be comparing the manual cost an the capital cost.
- The capital cost of improving working conditions or safety can be obtained through capital expenditure forecasting.
- It facilitates the management in making of the long-term plans an assists in the formulation of general policy.
- It studies the impact of capital investment on the revenue expenditure of the firm such as depreciation, insure and there fixed assets.

Limitations of Capital Budgeting

The limitations of capital budgeting are as follows:

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1. It has long term implementations which can't be used in short term and it is used as operations of the business. A wrong decision in the early stages can affect the long-term survival of the company. The operating cost gets increased when the investment of fixed assets is more than required.
2. Inadequate investment makes it difficult for the company to increase it budget and the capital.
3. Capital budgeting involves large number of funds so the decision has to be taken carefully.
4. Decisions in capital budgeting are not modifiable as it is hard to locate the market for capital goods.
5. The estimation can be in respect of cash outflow and the revenues/saving and costs attached which are with projects.