A

Seminar report

on

Capital Budgeting

Submitted in partial fulfillment of the requirement for the award of degree of MBA

SUBMITTED TO: **SUBMITTED BY:**

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Preface

I have made this report file on the topic **, Capital Budgeting,** I have tried my best to elucidate all the relevant detail to the topic to be included in the report. While in the beginning I have tried to give a general view about this topic.

My efforts and wholehearted co-corporation of each and everyone has ended on a successful note. I express my sincere gratitude to …………..who assisting me throughout the prepration of this topic. I thank him for providing me the reinforcement, confidence and most importantly the track for the topic whenever I needed it.

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Introduction

Capital Budgeting, broadly defined as a decision-making process that enables managers to evaluate and recognize projects that are valuable to the company, is usually the dominant mission facing any financial manager and his/her team. It is the most important task for managers for the following reasons.

First, the strategic decisions and directions of a company, new products, new services, and expansion into new markets, are determined by the company's capital budgeting. Second, capital budgeting decisions usually result in relatively long-lasting effects to the company, and therefore a decrease in flexibility. Third, serious consequences may arise from poor capital budgeting decisions.

For example, if a company devoted too much capital to one project, the company's capital would be unnecessarily spent on excess production capacity. On the other hand, if less-than-required capital was invested by the company, its productivity would suffer by the simple fact that its equipment, computer hardware and software might not be cutting-edge to improve production.

These poor capital budgeting decisions may allow rival companies the opportunity to steal market share by taking advantage of a lower cost structure or production capabilities matching demand.

Most textbooks classify capital budgeting projects roughly into the following five categories.

(1) Replacement projects: If a piece of equipment is out-dated or hinders efficient production, company's usually tends to avoid overanalyzing whether to replace the older equipment. This type of project is usually carried out without detailed analysis.

(2) Expansion projects: These projects expand the volume of the business product lines, and more uncertainties of sales forecasts should be considered. Very detailed analyses are usually involved in this instance.

(3) New products and services: New products and services require more complex decision-making processes, and careful capital budgeting decisions are necessary.

(4) Mandatory projects: These types of projects are required by the government, an insurance company, or some other agency. These projects are usually related to safety or the environment and are typically not revenue-generating. Capital budgeting decisions are typically made to reach the objective at the lowest cost to the company.

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What is Capital Budgeting?

Capital Budgeting is the process by which the firm decides which long-term investments to make. Capital Budgeting projects, i.e., potential long-term investments, are expected to generate cash flows over several years.

The Basic Steps of Capital Budgeting

Capital budgeting is the process of determining whether a big expenditure is in a company's best interest. Here are the basics of capital budgeting and how it works.

Capital Budgeting Basics

A company undertakes capital budgeting in order to make the best decisions about utilizing its limited capital.

For example, if you are considering opening a distribution center or investing in the development of a new product, capital budgeting will be essential. It will help you decide if the proposed project or investment is actually worth it in the long run.

Identify Potential Opportunities

The first step in the capital budgeting process is to identify the opportunities that you have. Many times, there is more than one available path that your company could take.

You have to identify which projects you want to investigate further and which ones do not make any sense for your company. If you overlook a viable option, it could end up costing you quite a bit of money in the long term.

Evaluate Opportunities

Once you have identified the reasonable opportunities, you need to determine which ones are the best. Look at them in relation to your overall business strategy and mission. See which opportunities are actually realistic at the present time and which ones should be put off for later.

Cash Flow

Next, you need to determine how much cash flow it would take to implement a given project. You also need to estimate how much cash would be brought in by such a project. This process is truly one of estimating--it takes a bit of guesswork.

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You need to try to be as realistic as you can in this process. Do not use the best-case scenario for your numbers. Most of the time, you need to use a fraction of that number to be realistic. If the project takes off and the best-case scenario is reached, that is great. However, the odds of that happening are not the best on new projects.

Select Projects

After you look at all of the possible projects, it is time to choose the right project mix for your company. Evaluate all of the different projects separately on their own merits.

You need to come up with the right combination of projects that will work for your company immediately. Choose only the projects that mesh with your company goals.

Implementation

Once the decisions have been made, it is time to implement the projects. Implementation is not really a budgeting issue, but you will have to oversee everything to be sure it is done correctly.

After the project gets started, you will need to review everything to make sure the finances still make sense.

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Needs

1. Long-term Implication

Capital expenditure decision affects the company's future cost structure over a long time span. The investment in fixed assets increases the fixed cost of the firm which must be recovered from the benefit of the same project.

If the investment turns out to be unsuccessful in future or give less profit than expected, the company will have to bear the extra burden of fixed cost. Such risk can be minimized through the systematic analysis of projects which is the integral part of investment decision.

2. Irreversible Decision

Capital investment decision are not easily reversible without much financial loss to the firm because there may be no market for second-hand plant and equipment and their conversion to other uses may not be financially viable.

Hence, capital investment decisions are to be carried out and performed carefully and effectively in order to save the company from such financial loss. The investment decision which is undertaken carefully and effectively can save the firm from huge financial loss aroused due to the selection of unfavorable projects.

3. Long-term Commitments Of Funds

Capital budgeting decision involves the funds for the long-term. So, it is long-term investment decision. The long-term commitment of funds leads to the financial risk. Hence, careful and effective planning is must to reduce the financial risk as much as possible.

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Capital Budgeting Techniques

- **Payback Period** measures the time in which the initial cash flow is returned by the project. Cash flows are not discounted. Lower payback period is preferred.
- **Net Present Value (NPV)** is equal to initial cash outflow less sum of discounted cash inflows. Higher NPV is preferred and an investment is only viable if its NPV is positive.
- **Accounting Rate of Return (ARR)** is the profitability of the project calculated as projected total net income divided by initial or average investment. Net income is not discounted.
- **Internal Rate of Return (IRR)** is the discount rate at which net present value of the project becomes zero. Higher IRR should be preferred.
- **Profitability Index (PI)** is the ratio of present value of future cash flows of a project to initial investment required for the project.

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Types of Capital budgeting

Last time I have discussed the process of capital budgeting with its importance. Toady we will discuss the different types of capital budgeting:

1.) Accept reject decisions: all the investment decisions which give more return than the cost of capital they are acceptable while the investment decisions which give less return than the cost of capital they are rejected. Thus firm will make investment only if the decision is acceptable.

2) Mutually exclusive decisions: these are the decisions which compete with each other which mean the acceptance of one automatically rejects the other decision. The firm has various alternatives; once one alternative is selected the other alternatives are automatically rejected.

3) Capital rationing or ranking decisions: in case the firm has various profitable investment proposals in that case the firm had only option to rank them as per their profitability and then accept them.

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Nature of Capital Budgeting

(a) Capital expenditure plans involve a huge investment in fixed assets.

(b) Capital expenditure once approved represents long-term investment that cannot be reserved or withdrawn without sustaining a loss.

(c) Preparation of coital budget plans involve forecasting of several years profits in advance in order to judge the profitability of projects.

Benefits of Capital Budgeting

Investment appraisal (or capital budgeting) is the process used by organizations to access whether long-term-infrastructure or investments are necessary for the success of the company. It can either be capital budget, investment or expenditures.

In other words, capital budgeting involve equitable distribution of funds/ resources in long-term schemes.

1. Consistency and flexibility
Anticipated business opportunities and possible constrains are easily developed based on the objectives of the company. Flexibility, on the other hand facilitates the strategic assessment of financing and capital budgeting, but consistency must be carefully deliberated before setting up any plan or objective.

Given the relationship between tactics, strategy and goals in the ever changing environment, capital budgeting is certainly of utmost importance when it comes to equitable distribution of resources.

2. Better financial decisions
With capital budgeting, it becomes easy to analyze several investment options, for example calculating profitability index and payback period. Business executives can use different tools to come up with different recommendations.

For this reason, make sure you use the most appropriate tool so that you can determine whether it makes financial sense to initiate long-term plans.

3. Access risk and uncertainty
Capital budgeting is the only sure way to access the risk involved when allocating more resources in long-term investments. We all know that any investment is clouded with

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risks and uncertainty therefore thorough assessment is necessary to make an informed decision whether or not to invest in long-term projects.

4. Analyze long-term repercussions

Capital budgeting has long-term effect on your business and unavoidably affects the organization's future growth and cost structure.

For this reason, the executive has to make a good financial decision since it affects the future of the company. In other words, capital budgeting will determine the success of the company.

Capital budgeting involves the use of several techniques that strive to estimate whether it is financially wise to initiate long-term projects. Most small businesses lack the know-how of implementing capital budgeting.

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Limitations

1 All the techniques of capital budgeting presume that various investment proposals under consideration are naturally exclusive which may not practically be true in some particular circumstances.

2. The technique of capital budgeting requires estimation of future cash flows and outflows. The future is always uncertain and the data collected for future may not be exact. Obviously, the results based upon wrong data can be good.

3. There are certain factors like morale of the employees, good-will of the firm etc.' which cannot be correctly quantified but which otherwise substantially influence the capital decision.

4. Urgency is another limitation in the evaluation of capital investment decisions.

5. Uncertainty and risk pose the biggest limitations to the techniques of capital budgeting.

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Conclusion

The fundamental difference between the classical approach to project capital investing and budgeting, with its emphasis on form as described by King, and contemporary practices, is the recognition of the need to employ systems that underpin the delivery of shareholder value.

By factoring cost of capital metrics (what companies need to return to investors and lenders) into discounting formulae such as Net Present Value (NPV) companies are effectively and efficiently enabled to identify satisfactory returns.

Compensating managers to achieve in excess of the shareholder return requirement is another key element of the modern approach.Shareholders want managers to invest only if the expected rate of return exceeds the cost of capital. Because of this managers cannot ignore the cost of capital imperative and indeed their focus should be on returns over and above the cost of capital.

This has given rise to a growing number of companies using EVA in manager compensation packages, especially since it resolves agency problems and generates incentives for managers to focus on increasing shareholder wealth.

It is hoped that contrasting the contemporary with the classical approach to capital budgeting and investing will have served to better illustrate the scope of this often complex subject. No apology is made to IT colleagues for the technical nature of some of the material above since technical, above all else, is what we are reputed to be.

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Reference

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