Lesson 7

Capital Budgeting: Concept, Importance and Scope

Objectives of the lesson

After studying this lesson, students will be able to:

- Understand concept, nature and need of capital budgeting,
- Describe scope and basic principles of capital budgeting decisions.

1.0 Introduction

Investment and financing of funds are two crucial functions of finance manager. The investment of funds requires a number of decisions to be taken in a situation in which funds are invested and benefits are expected over a long period. The finance manager of concern has to decide about the asset composition of the firm. The assets of the firm are broadly classified into two categories viz., fixed and current. The aspect of taking the financial decision with regard to fixed assets is known as capital budgeting.

2.0 Meaning of Capital Budgeting

The capital budgeting decision means a decision as to whether money should be invested in long-term projects. Such projects may include the setting up of a factory or installing machinery or creating additional capacities to manufacture a part which at present may be purchased from outside. According to Charles T. Hrongreen, “Capital budgeting is a long-term planning for making and financing proposed capital out lays.” The capital budgeting process includes (i) identification of investment projects, (ii) estimating post-tax incremental cash flows, (iii) evaluating alternatives, and (iv) selecting of best alternative.

Capital budgeting decisions includes a financial analysis of the various proposals regarding capital expenditure to evaluate their impact on the financial condition of the company for the purpose to choose the best out of the various alternatives. The finance manager has various tools and techniques by means of which he assists the management in taking a proper capital budgeting decision. The capital budgeting decisions therefore evaluate expenditure decisions which involve current outlays but are likely to produce benefits over a period longer than one year. The benefit which may arise from capital budgeting decisions may be either in the form of increased revenues or reduction in costs. A capital budgeting decision requires evaluation of a proposed project to forecast the likely or expected return from the project and determine whether return from the project is adequate.

The capital budgeting decisions are taken by both newly incorporated firms as well as by existing firms. These may be related with new investment, replacement and modernization, and expansion and diversification.

- New or Initial Investment: The new firms may be required to take decision in respect of selection of a plant to be installed. The existing firm may be required to take decisions to meet the requirement of new environment or to face the challenges of competition.
- Replacement and Modernization: The replacement and modernization aim at improving operating efficiency and reducing cost. Generally, all types of plant and machinery require replacement either because of the economic life of the plant or machinery is over or because it has become technologically outdated. The former decision is known as replacement decisions and later one is known as modernization decisions. Both replacement and modernization decisions are called cost reduction decisions.
- Expansion and Diversification: Existing successful firms may experience growth in demand of their product line. If such firms experience shortage or delay in the delivery of their products due to inadequate production facilities, they may consider proposal to add capacity to existing product line. Diversification decisions require evaluation of proposals to diversify into new product lines, new markets etc. for reducing the risk of failure by dealing in different products or by operating in several markets.

3.0 Nature of Capital Budgeting Problem

Capital budgeting problem is associated with:

- Demand of capital
- Supply of capital
- Allocation of capital
- Capital rationing

4.0 Need and Importance of Capital Budgeting

Capital budgeting decisions are critical and crucial business decisions because they involve:

- Substantial investment: Capital investment normally demands heavy volume of investment which is met out by the firm either through external or internal source of financing. Hence, the amount of capital raised by the firm should neither greater nor lesser than the investment.
- Long time period: Capital budgeting involves decision of capital expenditures which are for long period. It requires utmost rationality, otherwise it may result into over-capitalization.
- Locking up of capital: The amount invested requires long gestation for recovery. The longer gestation relates to future horizon in getting back the investment. The future is uncertain unlike the present. If the longer is the gestation in the future leads to greater risk involved.
- Nature of Irreversibility: The improper/ unwise capital expenditure decision cannot be immediately corrected as soon as it was found. Once it is invested is invested which cannot be reversed.

- Complexity: The expected benefit of an investment is generally unpredictable. The poor investment decision will require the firm either to keep it as an idle in the form of investment or to unnecessarily meet out fixed commitment charge of the capital which excessively rose more than the requirement.
- Profitability of the enterprise: The profitability of the enterprise mainly depends on the proper planning of the capital expenditure.

While capital expenditure decisions are extremely important, managers find it extremely difficult to analyze the pros and cons and arrive at a decision because:

- Measuring costs and benefits of an investment proposal is difficult because all costs and benefits cannot be expressed in tangible terms.
- The benefits of capital expenditure are expected to occur for several years in the future which is highly uncertain.
- Because the costs and benefits occur at different points of time, investment proposal, for a proper analysis of the viability of the all these must be brought to a common time frame. Hence time value of money becomes very relevant here.
- Capital budgeting decisions are among the most difficult to make when the company is faced with various potentially viable investment opportunities.

5.0 Scope/ Process of Capital Budgeting

The important dimensions or the steps to be followed for effective investment decision process are as follows.

- Identification of potential investments proposals
- Screening or matching the proposals
- Analysis and evaluation
- Selection of feasible investment proposals
- Implementation
- Performance review/ Feedback
- Control

6.0 Principles of Capital Budgeting

Important principles of capital budgeting (measurement of costs i.e. outflows, and inflows i.e. benefits) are as follows:

- All costs and benefits must be measured in terms of cash flows. This implies that all non-cash expenses like depreciation which are considered for the purpose of determining the profit after tax (PAT) must be added back to arrive at the net cash flows for our purpose.
- Since the net cash flows relevant from the firm's point of view are what that accrue to the firm after paying tax, cash flows for the purpose of appraisal must be defined in post-tax terms.

- The cash flows must be measured in incremental terms, i.e. increments in the present levels of costs and benefits that arise due to adoption of the project.
- Usually the net cash flows are defined from the point of view of the suppliers of long-term funds (i.e., suppliers of equity capital plus long-term loans).
- Sunk costs (Past costs) must be ignored money has already been sunk in it and no additional or incremental money is spent on it for the purposes of this project.
- Opportunity costs associated with the utilization of the resources available with the firm must be considered.
- Interest on long-term loans must not be included for determining the net cash flows.

Summary

Capital expenditure decisions occupy an important place in corporate finance. The capital budgeting decisions are taken by both newly incorporated firms as well as by existing firms. These may be related with new investment, replacement and modernization, and expansion and diversification. The huge sums involved, and the irreversible and long-term nature of the decisions make them very important. Investment decisions begin with identification of the investment opportunities, followed by preliminary screening, feasibility study, implementation and performance review.

Self check Questions

1. What is capital budgeting? What are various types of capital budgeting decisions?
2. Define capital budgeting. Discuss need and importance of capital budgeting in business decisions.
3. What are important principles of capital budgeting? Explain briefly nature and scope of capital budgeting.