TRINITY COLLEGE FOR WOMEN NAMAKKAL

Department of Commerce

FINANCIAL MANAGEMENT

21PCM03-ODD Semester

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CAPITAL BUDGETING

Introduction:

Capital Budgeting is the process of making investment decision in capital expenditure. It involves the planning and control of capital expenditure. It is the process of deciding whether or not to commit resources to particular long-term projects whose benefits are to be realized over a period of time.

- **According To Charles T Horngreen:** "Capital Budgeting is the long term planning for making and financing proposed capital outlays"
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- **According To Lynch:** "Capital Budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern."

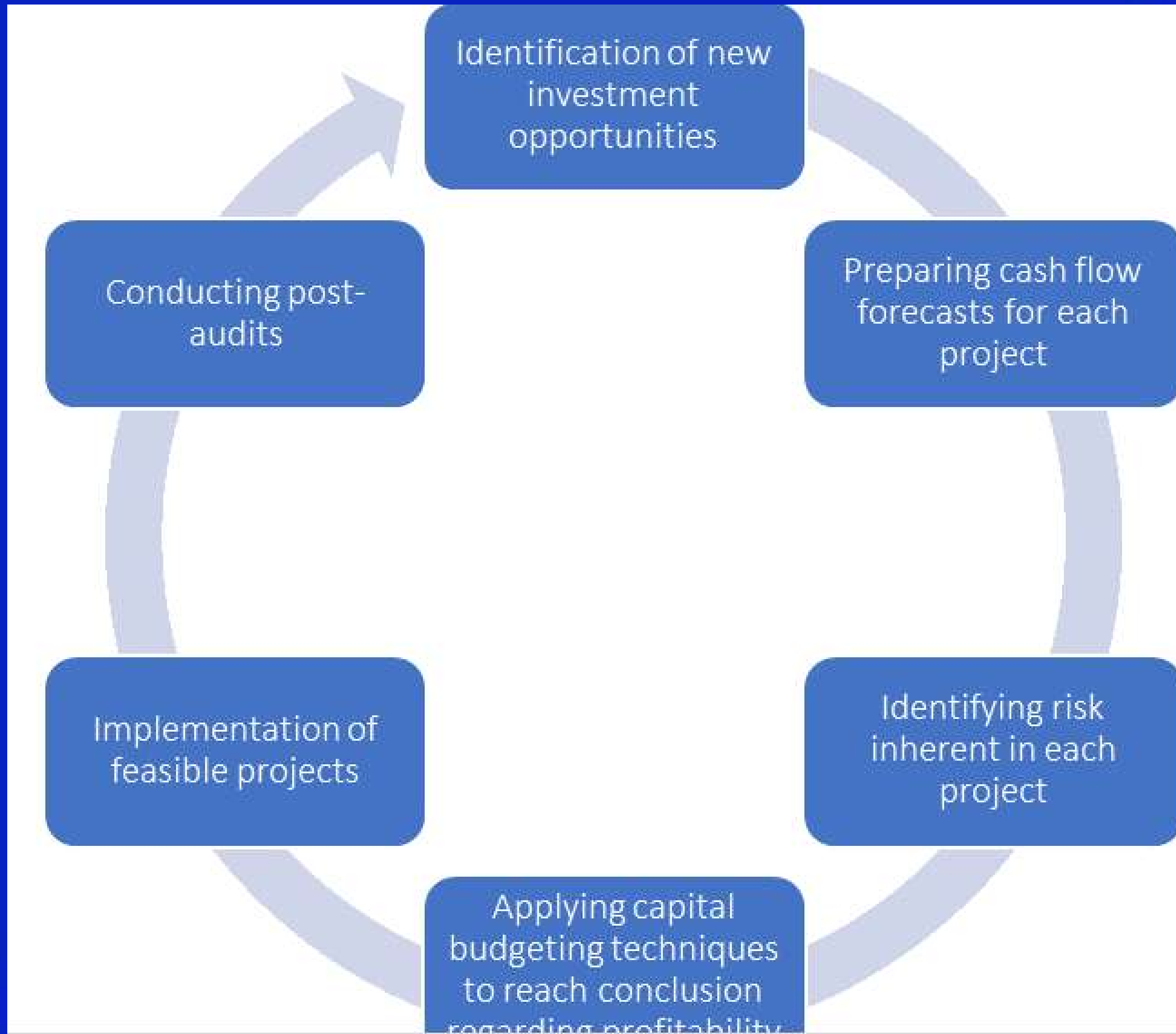
Features of Capital Budgeting

1. Exchange of funds for future benefits:
2. The future benefits are expected to be realized over a period of time.
3. The funds are invested vested in long-term activities.
4. They have a long term and significant effect on the profitability of the concern,
5. They involve huge funds.

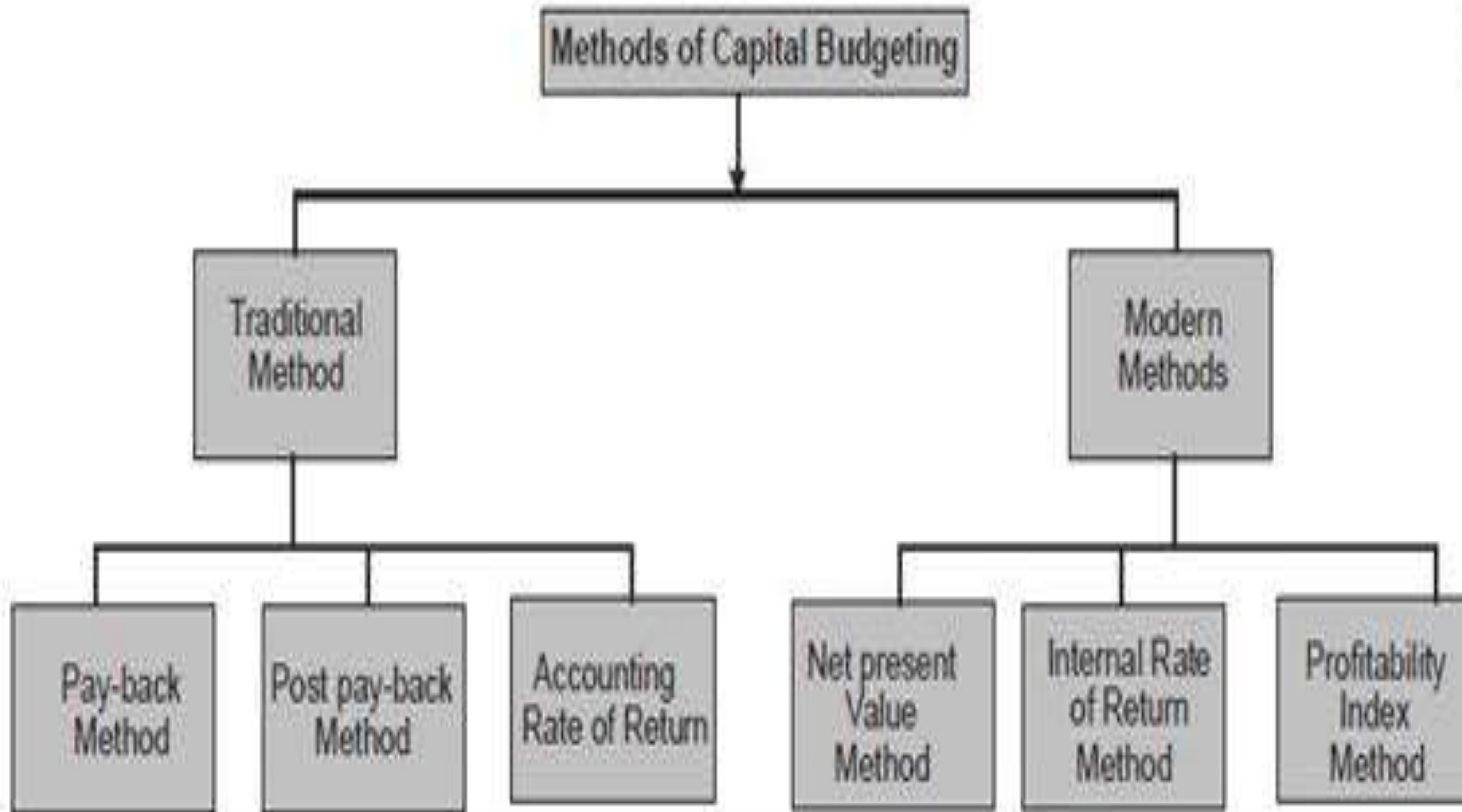
Importance of Capital Budgeting

1. Large Investment
2. Long Term Commitment of Funds
3. Irreversible Nature
4. Long term Effect on profitability
5. Difficulties of investment Decisions
6. National Importance

PROCESS OF CAPITAL BUDGETING



CAPITAL BUDGETING DECISION PROCESS



Traditional Method

- **Pay Back Period Method:** It represents the period in which the total investments in permanent assets pay backs itself.
- Pay Back Period = Original cost of the Asset / Annual Cash Flow

Average rate of return method (ARR): Under this method average profit after tax and deprecation is calculated and then it is divided by the total capital outlay or total investment in the project.

$$\frac{\text{Total Profits (after dep. \& taxes)}}{\text{Net Investment in project x No. Of years of profits}} \quad \text{X } 100$$

Or

$$\frac{\text{Average annual profit}}{\text{Net investment in the Project}} \quad \text{X } 100$$

Discounted Cash Flow Method

- **Net Present Value Method:** This method is the modern method of evaluating the investment proposals. This method takes into consideration the time value of money and attempts to calculate the return in investments by introducing the factor of time element.

Net Present Value = Present value of cash inflows – Present value of cash outflows

- **Internal Rate of Return Method:** It is a modern technique of capital budgeting that takes into account the time value of money. It is also known as "time adjusted rate of return discounted cash flows" "yield method" "trial and error yield method."

Determination of Internal Rate of Return:

1. **When the annual net cash flows are equal over the life of the assets.**

$$\text{Present value Factor} = \frac{\text{Initial Outlay}}{\text{Annual cash Flows}}$$

- **Profitability Index or PI:** This is also known as benefit cost ratio. This is similar to NPV method. The major drawback of NPV method that not does not give satisfactory results while evaluating the projects requiring different initial investments. PI method provides solution to this. PI is calculated as:
- $$PI = \frac{\text{Present value of cash Inflows}}{\text{Present value of cash outflows}}$$

THANK YOU

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