

Capital Budgeting

An introduction



Edit with WPS Office

Capital Budgeting: Meaning

- The investment decisions involving commitment of Current funds of the firm in its long term assets are known as Capital Budgeting.
- Capital Budgeting involves investment of current cash outlays or a series of cash outlays in long term assets of the firm in return for future benefits in form of cash inflows.
- It is also known as Capital Expenditure decisions.
- It is a situation where the lump sum funds are invested in the initial stages of a projects and the returns are expected over a period of time.



Capital Budgeting: Meaning

Charles T. Horngren defined “capital budgeting as a long term planning for making and financing proposed capital outlays.”

According to R.N. Anthony, “ Capital expenditure is defined as “ any investment involving commitment of funds now with the expectations of earning a satisfactory return on these funds over a period of time in future.”

According of John J. Hampton, “Capital Budgeting is concerned with the firm’s formal process for the acquisition and investment of capital.”



Capital Budgeting

Capital budgeting incorporates decisions such as:

- Acquisition of long term assets like plants, machineries, buildings etc.
- Modification of the existing facilities for enhancing capacities
- Replacement of existing assets for cost reduction or profit maximization
- Development of new products or their new use.
- Manufacturing process improvement
- Research and Development
- Incorporation of new technology
- Acquisition of new business



Importance of Capital Budgeting Decision

- Long term implications
- Substantial Commitment of funds
- Change the Risk complexion of the firm
- Irreversible decision
- Influence the capacity and strength to compete
- Difficult and complex Decision



Objective of Capital Budgeting

- The main objective of financial management is wealth maximization.
- Maximization of wealth of the firm indicates the maximization of value of owner's share capital.
- Maximization of wealth is a useful and meaningful objective criterion to take all type of finance function's decisions including capital budgeting decision.



Problems in Capital Budgeting

- Risk and Uncertainty
- Time Element
- Measurement problem
- Capital Rationing

