Capital Budgeting

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1. Definition

- Capital budgeting is the process of planning and managing a firm's long-term investments in projects and assets. It involves evaluating the potential profitability and feasibility of investments to make informed decisions on allocating financial resources.

2. Importance

- Crucial for strategic decision-making to ensure long-term growth and profitability.
- Helps in maximizing shareholder value by selecting investments with the highest potential return.

3. Methods of Capital Budgeting a. **Payback Period**: Measures the time required for the initial investment to be recovered. b. **Net Present Value (NPV)**: Calculates the present value of cash inflows and outflows to determine if a project is financially viable. c. **Internal Rate of Return (IRR)**: Calculates the discount rate that makes the NPV of a project zero, indicating the project's rate of return. d. **Profitability Index (PI)**: Compares the present value of future cash flows to the initial investment.

4. Factors to Consider

- Cost of capital
- Risk and uncertainty
- Timing of cash flows
- Market conditions and competition
- Strategic alignment with business goals

5. Decision Criteria

- Projects with positive NPV should be accepted, as they increase shareholder wealth.
- Projects with IRR higher than the cost of capital are deemed acceptable.
- Payback period is used for quick assessment of liquidity and risk.

6. Limitations

- Relies on estimates and predictions which may not always be accurate.

- Ignores qualitative factors such as managerial expertise, market trends, and non-financial impacts.

7. Steps in the Capital Budgeting Process a. Identification of potential investments b. Estimation of cash flows and costs c. Evaluation using appropriate methods d. Selection and approval of projects e. Implementation and monitoring of selected projects

8. Conclusion Capital budgeting is a critical process for firms to make informed decisions on long-term investments. By carefully evaluating and selecting projects based on financial metrics and strategic alignment, organizations can enhance their competitiveness and create long-term value for stakeholders.