

Capital Budgeting Techniques

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1. Net Present Value (NPV)

- Calculates the present value of future cash flows minus the initial investment.
- Decision Rule: Accept if NPV is positive; the higher the NPV, the better.

2. Internal Rate of Return (IRR)

- Determines the discount rate that makes the present value of cash inflows equal to the initial investment.
- Decision Rule: Accept if IRR is greater than the required rate of return.

3. Payback Period

- Measures the time required to recover the initial investment.
- Decision Rule: Accept if payback period is less than a set benchmark.

4. Profitability Index (PI)

- Compares the present value of future cash flows to the initial investment.
- Decision Rule: Accept if PI is greater than 1.

5. Accounting Rate of Return (ARR)

- Calculates the average accounting profit as a percentage of the initial investment.
- Decision Rule: Accept if ARR is greater than the target rate.

6. Modified Internal Rate of Return (MIRR)

- Overcomes some limitations of IRR by assuming reinvestment at a different rate.
- Decision Rule: Accept if MIRR is greater than the required rate of return.

7. Real Options Analysis

- Incorporates flexibility and strategic value of investment decisions.
- Considers options to expand, delay, or abandon a project based on changing conditions.

8. Sensitivity Analysis

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- Examines how changes in key variables impact the project's viability.
- Helps assess the project's sensitivity to fluctuations in assumptions.

9. Scenario Analysis

- Considers multiple possible scenarios and their impact on the project.
- Helps in understanding the range of potential outcomes based on different assumptions.

10. Monte Carlo Simulation

- Utilizes random variables to model different possible outcomes.
- Provides a more comprehensive view of the project's risks and potential returns.