Meaning, Nature and Need of Capital Budgeting

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INTRODUCTION

- The term Capital Budgeting refers to long term planning for proposed capital outlay and their financing. It includes raising long-term funds and their utilization. It may be defined as a firm's formal process of acquisition and investment of capital.

- It deals exclusively with investment proposals, which an essentially long term projects and is concerned with the allocation of firm's scarce financial resources among the available market opportunities.

Meaning

- The process through which different projects are evaluated is known as capital budgeting.
- Capital budgeting is the firm’s formal process for the acquisition and investment of capital. It involves firm’s decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets.
- “Capital budgeting is long term planning for making and financing proposed capital outlays”- Charles T Horngreen.

Definitions of capital budgeting

- "The decision making process by which a firm evaluates the purchase of major fixed assets. It involves firm's decision to invest its current funds for addition, disposition, modification and replacement of fixed assets”.
- “Capital budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern” – Lynch

NATURE OF CAPITAL BUDGETING

- Capital expenditure plans involve a huge investment in fixed assets.
- Capital expenditure once approved represents long-term investment that cannot be reserved or withdrawn without sustaining a loss.
- Preparation of capital budget plans involve forecasting of several years profits in advance in order to judge the profitability of projects.
- It may be asserted that ,decision regarding capital investment should be taken very carefully so that the future plans of the company are not affected adversely.

Need and Importance of capital budgeting

- The success and failure of business mainly depends on how the available resources are being utilised.
- Main tool of financial management.
- All types of capital budgeting decisions are exposed to risk and uncertainty.
- They are irreversible in nature.
- Capital rationing gives sufficient scope for the financial manager to evaluate different proposals and only viable project must be taken up for investment.
- Capital Budgeting offers effective control on cost of capital expenditure projects.
- It helps the management to avoid over investment and under investments.

PROCESS

- **Initiating,** generating and gathering investments ideas.
- **Analyzing** the costs and benefits for proposed investments by:
  - *Forecasting* costs and benefits for each investment.
  - *Evaluating* the costs and benefits based on **CB** techniques.
- **Ranking** the relative superiority of each investment alternative based on financial performance worked out and choosing the best investment opportunity from the given set of opportunities.
- **Implementing** the investment alternative chosen.
- **Monitoring & making follow-up** on the investment made on regular basis to see how far this investment opportunity has been effective in the given framework of the company to achieve its desired objectives.

Need for Capital Budgeting

- As large sum of money is involved which influences the profitability of the firm making capital budgeting an important task.
- Long term investment once made can not be reversed without significant loss of invested capital. The investment becomes sunk, and mistakes, rather than being readily rectified, must often be borne until the firm can be withdrawn through depreciation charges or liquidation. It influences the whole conduct of the business for the years to come.
- Investment decision are the based on which the profit will be earned and probably measured through the return on the capital. A proper mix of capital investment is quite important to ensure adequate rate of return on investment, calling for the need of capital budgeting.
- The Implication of long term investment decision are more extensive than those of short run decision because of time factor involved, capital budgeting decision are subject to the higher degree of risk and uncertainty than short run decision.

Types of Capital Expenditure

- Capital Expenditure can be of two types :

 Capital Expenditure Increases Revenue: It is the expenditure which brings more revenue to the firm either by expanding the existing production facilities or development of new production line.

 Capital Expenditure Reduces Costs: Such a capital expenditure reduces the cost of present product and thereby increases the profitability of existing operations. It can be done by replacement of old machine by a new one.

THANKS