UNIT -1 DECISION MAKINK

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1.CAPITAL BUDGETING

Definition: Capital budgeting is a method of analyzing and comparing substantial future investments and expenditures to determine which ones are most worthwhile. In other words, it's a process that company management uses to identify what capital projects will create the biggest return compared with the funds invested in the project. Each project is ranked by its potential future return, so the company management can choose which one to invest in first.

Meaning... Capital budgeting is the process a business undertakes to evaluate potential major projects or investments. Construction of a new plant or a big investment in an outside venture are examples of projects that would require capital budgeting before they are approved or rejected.

As part of capital budgeting, a company might assess a prospective project's lifetime cash inflows and outflows to determine whether the potential returns that would be generated meet a sufficient target benchmark. The process is also known as investment appraisal.
Most business' future goals include expanding their operations. This is difficult to do if the company doesn't have enough capital or fixed assets. That is where capital budgeting comes into play.

Capital budgets or capital expenditure budgets are a way for a company's management to plan fixed asset sales and purchases. Usually these budgets help management analyze different long-term strategies that the company can take to achieve its expansion goals. In other words, the management can decide what assets it might need to sell or buy in order to expand the company. To make this decision, management typically uses these three main

analyzes in the budgeting process: throughput analysis, discounted cash flows analysis, and payback analysis.

Objectives of Capital budgeting

Capital expenditures are huge and have a long-term effect. Therefore, while performing a capital budgeting analysis an organization must keep the following objectives in mind:

1. Selecting profitable projects

An organization comes across various profitable projects frequently. But due to capital restrictions, an organization needs to select the right mix of profitable projects that will increase its shareholders' wealth.

2. Capital expenditure control

Selecting the most profitable investment is the main objective of capital budgeting. However, controlling capital costs is also an important objective. Forecasting capital expenditure requirements and budgeting for it, and ensuring no investment opportunities are lost is the crux of budgeting.

3. Finding the right sources for funds

Determining the quantum of funds and the sources for procuring them is another important objective of capital budgeting. Finding the balance between the cost of borrowing and returns on investment is an important goal of Capital Budgeting.

Capital Budgeting Process

1. Identifying investment opportunities

An organization needs to first identify an investment opportunity. An investment opportunity can be anything from a new business line to product expansion to purchasing a new asset. For example, a company finds two new products that they can add to their product line.

2. Evaluating investment proposals

Once an investment opportunity has been recognized an organization needs to evaluate its options for investment. That is to say, once it is decided that new product/products should be added to the product line, the next step would be deciding on how to acquire these products. There might be multiple ways of acquiring them. Some of these products could be:

- Manufactured In-house
- Manufactured by Outsourcing manufacturing the process, or
- Purchasedfromthemarket

3. Choosing a profitable investment

Once the investment opportunities are identified and all proposals are evaluated an organization needs to decide the most profitable investment and select it. While selecting a particular project an organization may have to use the technique of capital rationing to rank the projects as per returns and select the best option available.