

Quadrant II- Notes

Paper Code : COD119

Module Name: Kinds of capital budgeting decision

Meaning of Capital Budgeting

Capital budgeting maybe defined as the decision making process by which a firm evaluates the purchase of fixed assets. It deals exclusively with major long term investment proposals the benefit of which are expected to be received over a period of time exceeding one year. It is concerned with allocation of firms' scarce financial resources among the available market opportunities. It involves a long term planning for making and financing proposed capital outlays.

The main characteristic of a Capital budgeting expenditure is that the investment is incurred at one point of time whereas the benefits of the expenditure are realized at different points of time in the future, i.e., in more than one year as opposed to revenue expenditure, the benefit of which is supposed to be exhausted within the year concerned.

- Further in investment proposals under consideration , capital budgeting decisions is classified as:
- (I) Accept Reject Decision
- (II) Mutually Exclusive Decision
- (III) Capital Rationing decision

I. **ACCEPT REJECT DECISION**

- The proposals which yield a higher rate of return in comparison with a certain rate of return or cost of capital are accepted and, naturally, the others are rejected.
- Related to independent projects which do not compete with each other.
- Example, if the minimum acceptable return from Project A is, say, 10%, after tax, and an investment proposal which shows a return of 12% may be accepted and another project which gives a return of 8% only may be rejected.
- Net Present Value Method Criterion, an investment opportunity will be accepted if $NPV > 0$, or, the same will be rejected if $NPV < 0$. That is, all independent projects are accepted under this criterion.
- Independent projects are those which do not compete with one another, i.e. the acceptance of one automatically rejects the acceptance of the other. At the same

time, those projects which will satisfy the minimum investment criterion should be taken into consideration.

II. MUTUALLY EXCLUSIVE PROJECT DECISION

- The decisions which compete with each other which mean the acceptance of one automatically rejects the other decision. The firm has various alternatives; once one alternative is selected the other alternatives are automatically rejected.

Example A company may have a option of buying a new machine or a second hand machine or taking an old machine on hire. In such a case the company would select one best alternative and other would be rejected automatically.

III. CAPITAL DECISION OR RAKING DECISION

- In case the firm has various profitable investment proposals in that case the firm had only option to rank them as per their profitability and then accept them.
- Capital rationing occurs when a firm has more acceptable proposals than it can finance. At this point, the firm ranks the projects from highest to lowest priority and, as such, a cut-off point is considered.
- Capital rationing is normally applied to situations where the supply of funds to the firm is limited in some way.