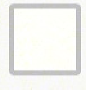
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How do you do capital budgeting tools

Under the internal rate of return method, determine the discount rate at which the cash flows from a project net to zero. The project with the highest internal rate of return (IRR) is selected. The weakness of this approach is that the projects selected are not necessarily linked to the strategic direction of the business.Constraint AnalysisUnder the constraint analysis method, examine the impact of a proposed project on the bottleneck operation of the business. If the proposal either increases the capacity of the bottleneck or routes work around the bottleneck, thereby increasing throughput, then accept the funding proposal. This is perhaps the strongest capital budgeting method, since it focuses attention on just those areas that directly impact overall company profitability.Breakeven AnalysisUnder the breakeven analysis method, determine the required sales level at which a proposal will result in positive cash flow. If the sales level is low enough to be reasonably attainable, then accept the funding proposal. This approach sets a minimum threshold for the projects to be selected.Discounted PaybackUnder the discounted payback method, determine the amount of time it will take for the discounted cash flows from a proposal to earn back the initial investment. If the period is sufficiently short, then accept the proposal. This approach emphasizes a fast payback, and so is more appropriate when long-term returns are uncertain.Accounting Rate of ReturnUnder the accounting rate of return method, one would calculate the ratio of an investment’s average annual profits to the amount invested in it. If the outcome exceeds a threshold value, then an investment is approved. This approach should not be used, since it does not account for the time value of money.Real OptionsUnder the real options method, one would focus on the range of profits and losses that may be encountered over the course of the investment period. The analysis begins with a review of the risks to which a project will be subjected, and then models for each of these risks or combinations of risks. The result may be greater care in placing large bets on a single likelihood of probability.Complexity ConsiderationsWhen analyzing a possible investment, it is useful to also analyze the system into which the investment will be inserted. If the system is unusually complex, it is likely to take longer for the new asset to function as expected within the system. The reason for the delay is that there may be unintended consequences that ripple through the system, requiring adjustments in multiple areas that must be addressed before any gains from the initial investment can be achieved. Capital budgeting techniques are the methods to evaluate an investment proposal in order to help the company decide upon the desirability of such a proposal. These techniques are categorized into two heads : traditional methods and discounted cash flow methods. Traditional MethodsTraditional methods determine the desirability of an investment project based on its useful life and expected returns. Furthermore, these methods do not take into account the concept of time value of money. Pay Back Period MethodPayback period refers to the number of years it takes to recover the initial cost of an investment. Therefore, it is a measure of liquidity for a firm. Thus, if an entity has liquidity issues, in such a case, shorter a project’s payback period, better it is for the firm. Therefore,Payback period = Full years until recovery + (unrecovered cost at the beginning of the last year)/Cash flow during the last yearHere, full years until recovery is nothing but the payback that occurs when cumulative net cash flow equals to zero. Cumulative net cash flow is the running total of cash flows at the end of each time period. Average Rate of Return Method (ARR)Under ARR method, the profitability of an investment proposal can be determined by dividing average income after taxes by average investment, which is average book value after depreciation. Thus, ARR = Average Net Income After Taxes/Average Investment x 100Where, Average Income After Taxes = Total Income After Taxes/Total Number of YearsAverage Investment = Total Investment/2Based on this method, a company can select those projects that have ARR higher than the minimum rate established by the company. And, it can reject the projects having ARR less than the expected rate of return. Discounted Cash Flow MethodsAs mentioned above, traditional methods do not take into the account time value of money. Rather, these methods take into consideration present and future flow of incomes. However, the DCF method accounts for the concept that a rupee earned today is worth more than a rupee earned tomorrow. This means that DCF methods take into account both profitability and time value of money. Net Present Value Method (NPV)NPV is the sum of the present values of all the expected incremental cash flows of a project discounted at a required rate of return less than the present value of the cost of the investment. In other words, NPV is the difference between the present value of cash inflows of a project and the initial cost of the project. As per this technique, the projects whose NPV is positive or above zero shall be selected. If a project’s NPV is less than zero or negative, the same must be rejected. Further, if there is more than one project with positive NPV, then the project with the highest NPV shall be selected. NPV = CF1/(1 + k)1 + ……….. CFn/ (1 + k)n + CF0where CF0 = Initial Investment Outlay (Negative Cash flow) CFt = after tax cash flow at time t k = required rate of returnInternal Rate of Return (IRR)Internal Rate of Return refers to the discount rate that makes the present value of expected after-tax cash inflows equal to the initial cost of the project. In other words, IRR is the discount rate that makes present values of a project’s estimated cash inflows equal to the present value of the project’s estimated cash outflows. If IRR is greater than the required rate of return for the project, then accept the project. And if IRR is less than the required rate of return, then reject the project. PV (inflows) = PV (outflows)NPV = 0 = CF0 + CF1/(1 + IRR)1 + ……….. CFn/ (1 + IRR)n + CF0Profitability IndexProfitability Index is the present value of a project’s future cash flows divided by initial cash outlay. Thus, it si closely related to NPV. NPV is the difference between the present value of future cash flows and the initial cash outlay. Whereas, PI is the ratio of the present value of future cash flows and initial cash outlay. PI = PV of future cash flows/CF0 = 1 + NPV/CF0Thus, if the NPV of a project is positive, PI will be greater than 1. If NPV is negative, PI will be less than 1. Therefore, based on this, if PI is greater than 1, accept the project otherwise reject. Reference MaterialThus, the manager has to evaluate the project in terms of costs and benefits as all the investment possibilities may not be rewarding. This evaluation is done based on the incremental cash flows from a project, opportunity costs of undertaking the project, timing of cash flows and financing costs.Therefore, it is the planning of expenditure and benefit that spreads over a number of years.Capital budgeting process used by managers depends upon size and complexity of the project to be evaluated, size of the organization and the position of the manager in the organization. establish norms for a company on the basis of which it either accepts or rejects an investment project. The most widely used techniques in estimating cost-benefit of investment projects.These methods are used to evaluate the worth of an investment project depending upon the accounting information available from a company’s books of accounts.Which is a significant factor to determine the desirability of an investment project in terms of present value?payback period is determined from the cumulative cash flows in the following way SHARE US WITH YOUR NETWORK!In our last article, we talked about the Basics of Capital Budgeting, which covered the meaning, features and Capital Budgeting Decisions. In this article let us talk about the important techniques adopted for capital budgeting along with its importance and example.Become an expert in Capital Budgeting? CAPITAL BUDGETING TECHNIQUES / METHODSThere are different methods adopted for capital budgeting. The traditional methods or non discount methods include: Payback period and Accounting rate of return method. The discounted cash flow method includes the NPV method, profitability index method and IRR.As the name suggests, this method refers to the period in which the proposal will generate cash to recover the initial investment made. It purely emphasizes on the cash inflows, economic life of the project and the investment made in the project, with no consideration to time value of money. Through this method selection of a proposal is based on the earning capacity of the project. With simple calculations, selection or rejection of the project can be done, with results that will help gauge the risks involved. However, as the method is based on thumb rule, it does not consider the importance of time value of money and so the relevant dimensions of profitability.Payback period = Cash outlay (investment) / Annual cash inflowExampleProject AProject BCost1,00,0001,00,000Expected future cash flowYear 150,0001,00,000Year 250,0005,000Year 31,10,0005,000Year 4NoneNoneTOTAL2,10,0001,10,000Payback2 years1 yearPayback period of project B is shorter than A, but project A provides higher returns. Hence, project A is superior to B. Need Guidance? Ask from Experts! Accounting rate of return method (ARR):This method helps to overcome the disadvantages of the payback period method. The rate of return is expressed as a percentage of the earnings of the investment in a particular project. It works on the criteria that any project having ARR higher than the minimum rate established by the management will be considered and those below the predetermined rate are rejected.This method takes into account the entire economic life of a project providing a better means of comparison. It also ensures compensation of expected profitability of projects through the concept of net earnings. However, this method also ignores time value of money and doesn’t consider the length of life of the projects. Also it is not consistent with the firm’s objective of maximizing the market value of shares.ARR= Average income/Average InvestmentDiscounted cash flow method:The discounted cash flow technique calculates the cash inflow and outflow through the life of an asset. These are then discounted through a discounting factor. The discounted cash inflows and outflows are then compared. This technique takes into account the interest factor and the return after the payback period.Net present Value (NPV) Method:This is one of the widely used methods for evaluating capital investment proposals. In this technique the cash inflow that is expected at different periods of time is discounted at a particular rate. The present values of the cash inflow are compared to the original investment. If the difference between them is positive (+) then it is accepted or otherwise rejected. This method considers the time value of money and is consistent with the objective of maximizing profits for the owners. However, understanding the concept of cost of capital is not an easy task.The equation for the net present value, assuming that all cash outflows are made in the initial year (tg), will be:Where A1, A2…. represent cash inflows, K is the firm’s cost of capital, C is the cost of the investment proposal and n is the expected life of the proposal. It should be noted that the cost of capital, K, is assumed to be known, otherwise the net present, value cannot be known.NPV = PVB – PVCwhere,PVB = Present value of benefitsPVC = Present value of Costs Internal Rate of Return (IRR):This is defined as the rate at which the net present value of the investment is zero. The discounted cash inflow is equal to the discounted cash outflow. This method also considers time value of money. It tries to arrive to a rate of interest at which funds invested in the project could be repaid out of the cash inflows. However, computation of IRR is a tedious task.It is called internal rate because it depends solely on the outlay and proceeds associated with the project and not any rate determined outside the investment.It can be determined by solving the following equation:If IRR > WACC then the project is profitable.If IRR > k = acceptIf IR < k = rejectProfitability Index (PI):It is the ratio of the present value of future cash benefits, at the required rate of return to the initial cash outflow of the investment. It may be gross or net, net being simply gross minus one. The formula to calculate profitability index (PI) or benefit cost (BC) ratio is as follows.PI = PV cash inflows/Initial cash outlay A,PI = NPV (benefits) / NPV (Costs)All projects with PI > 1.0 is accepted.IMPORTANCE OF CAPITAL BUDGETING1) Long term investments involve risks: Capital expenditures are long term investments which involve more financial risks. That is why proper planning through capital budgeting is needed.2) Huge investments and irreversible ones: As the investments are huge but the funds are limited, proper planning through capital expenditure is a pre-requisite. Also, the capital investment decisions are irreversible in nature, i.e. once a permanent asset is purchased its disposal shall incur losses.3) Long run in the business: Capital budgeting reduces the costs as well as brings changes in the profitability of the company. It helps avoid over or under investments. Proper planning and analysis of the projects helps in the long run.SIGNIFICANCE OF CAPITAL BUDGETINGCapital budgeting is an essential tool in financial managementCapital budgeting provides a wide scope for financial managers to evaluate different projects in terms of their viability to be taken up for investmentsIt helps in exposing the risk and uncertainty of different projectsIt helps in keeping a check on over or under investmentsThe management is provided with an effective control on cost of capital expenditure projectsUltimately the fate of a business is decided on how optimally the available resources are usedExample of Capital Budgeting:Capital budgeting for a small scale expansion involves three steps: recording the investment’s cost, projecting the investment’s cash flows and comparing the projected earnings with inflation rates and the time value of the investment.For example, equipment that costs $15,000 and generates a $5,000 annual return would appear to "pay back" on the investment in 3 years. However, if economists expect inflation to rise 30 percent annually, then the estimated return value at the end of the first year ($20,000) is actually worth $15,385 when you account for inflation ($20,000 divided by 1.3 equals $15,385). The investment generates only $385 in real value after the first year.Capital Budgeting is an interesting concept and a high in demand skill among organizations globally. Learning capital budgeting requires professional guidance to cover the complexities of the topic well. There are courses that are focused on cost accounting and budgeting and cover the topic extensively. Pursuing a course in Management Accounting also trains the candidate on capital budgeting. Below are two courses that can be pursued to learn capital Budgeting in depth: US CMA – Certified Management Accountant The US CMA course is offered by IMA, an institute based in the United States. US CMA course covers Management Accounting as the major domain in accounting. Management Accounting being different than generic accounting is a specialized domain and requires specialized training.For details on the US CMA course like US CMA course eligibility, US CMA course scope, US CMA course duration, contact our counsellors. ACCA – Chartered Certified Accountants The ACCA course is offered by an accounting body in the United Kingdom. The ACCA course is a great combination of general accounting and management accounting. That means a candidate gets to learn and excel in every domain of accounting, including financial accounting and management accounting. The ACCA course also defines exemptions for certain exams and levels depending on the academic and work background of the candidate.For details on the ACCA course like ACCA course eligibility, ACCA course scope, ACCA course duration, contact our counsellors. Conclusion:According to the definition of Charles T. Hrongreen, “Capital Budgeting is a long-term planning for making and financing proposed capital outlays.”One can conclude that capital budgeting is the attempt to determine the future.

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