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Subject: Financial Management

Paper : MB 205

Topic: Concept and Significance of Capital Budgeting

There are four types of decisions which are taken by the Financial Manager in any corporate concern such as financing decision investment decision, liquidity decision and dividend decision. So far investment decision is concerned, It is generally taken at the time of using the long term fund or fixed capital for acquisition and replacement of fixed assets as well as when schemes of growth and expansion is executed in the form of diversification, expansion, modernization and mechanization of any business enterprise. Such decision is always based on cost and benefit principle of accounting. Thus, cost of capital and capital budgeting are two important components of investment decision. Cost of capital gives information about the cost at which long term fund has been obtained by the concern and capital budgeting gives information about the benefit as expected against investment of long term fund in acquisition, replacement, expansion diversification, modernization, computerization & mechanization proposal of the concern. Hence, capital budgeting is one of the important leg of the investment decision which is also known as capital expenditure decision, capital expenditure planning, project planning etc.

Thus, we find that capital budgeting is the process of making investment decisions in capital expenditures. A capital expenditure may be defined as expenditure where the benefits are expected to be received over period of time exceeding one year. The main feature of capital expenditure is that the expenditure is incurred at one point of time where as the benefit of the expenditure are realized at different points of time in future. The following are some of the examples of capital expenditure:

- (i) Cost of acquisition of permanent assets such as land and building, plant and machinery goodwill etc.
- (ii) Cost of addition, expansion, improvement or alteration in the fixed assets
- (iii) Cost of replacement of permanent assets
- (iv) Research and development project cost

This shows that capital expenditure involves non flexible long term commitment of funds. So far capital budgeting is concerned it involves the planning and control to capital expenditure. In this way, we find that capital budgeting is concerned with the allocation of the firms scarce financial resources among the available market opportunities where the investment is made immediately but the benefit is expected in future. Thus, capital budgeting decision has the following distinctive features.

- (i) Capital budgeting decisions involve the exchange of current funds for the benefits to be achieved in future.
- (ii) The future benefits are expected to be realized over a series of years.
- (iii) The funds are invested in non - flexible and long term activities
- (iv) They have a longterm and significant effect on the profitability of the concern.
- (v) They involve generally huge funds
- (vi) They are irreversible decisions or reversible at substantial loss
- (vii) They are among the most difficult decisions to make.
- (viii) They affect the risk of the firm

In this way we can say that capital budgeting is one of the important component of investment decision where available market opportunities in which a concern wants to invest long term fund are evaluated by keeping in view their benefit as expected over a number of years for ensuring effective utilization of long term fund during the period.

Thus, capital budgeting may be defined as the firms decision to invest its current funds most efficiently in the long term assets in anticipation of an expected flow of benefits over a series of years. It is the process of identifying, analyzing and selecting investment projects whose return cash flows are expected to extend beyond one years.

Need/Importance/Significance of capital budgeting

The importance of capital budgeting can be well understood from the fact that an unsound investment decision may prove to be fatal for the existence of the concern. The need, significance or importance of capital budgeting arises mainly due to the following:

- (i) Large investment: Capital budgeting decision generally involve large investment of funds. The funds available with the firm are always limited and the demand for funds is very high. Hence, it is very important for a firm to plan and control its capital expenditure very carefully.

- (ii) Long term commitment of funds: Capital expenditure involves not only large amount of funds but also funds for long term or more or less on permanent basis. The long term commitment of funds increases the financial risk involved in the investment decision. Greater the risk involved, greater is the need for careful planning of capital expenditure that is capital budgeting.
- (iii) Irreversible nature: The capital expenditure decisions are of irreversible nature. Once the decisions for acquiring a permanent asset is taken, it becomes very difficult to dispose of these assets without incurring heavy losses.
- (iv) Long term effect on profitability: Capital budgeting decisions have a long term and significant effect on the profitability of a concern. Not only the present earnings of the firm are effected by the investment in capital assets but also the future growth and profitability of the firm depends upon the investment decision taken today. An unwise decision may prove disastrous and fatal to the very existence of the concern. Capital budgeting is of utmost importance to avoid over investment or under investment in fixed assets.
- (v) Difficulties of investment decisions: The long term investment decisions are difficult to be taken because (i) decision extends to a series of years beyond the current accounting period (ii) Uncertainties of future (iii) higher degree of risk.
- (vi) National importance: Investment decision though taken by individual concern is of national importance because it determines employment, economic activities and economic growth.

Thus, capital budgeting seems to be very significant from the angle of ensuring effective utilization of long-term fund in any corporate concern. There is no doubt that capital budgeting helps in the optimum utilization of available long term fund in the business firm. It is the capital budgeting through which a firm is in a position to acquire fixed assets and replace them at the right time. Capital budgeting is very helpful in minimizing risk and maximizing the return in the long term investment of fund during the period. It removes over allocation or under allocation of fund in any fixed asset. The provision of fund for expansion, modernization and any scheme of growth is made possible only with the help of capital budgeting. Thus, growth and profitability of any concern is directly linked with the capital budgeting. A concern is benefitted in different ways with the help of capital budgeting. Capital budgeting ensures stability of any corporate concern.