# Capital budgeting

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# CAPITAL BUDGETING

# INTRODUCTION

Every business concern has to face very often to the problem of capital expenditure is a vital part of policy making, management and control.

Capital expenditure is one which is in tended to benefit future periods and normally includes investment in fixed assets and their development project. It is essential for a long term investment decision.

# INVESTMENT METHOD

There are two methods of evaluating profitability of capital investment decisions.

1. Traditional or Non time value method.
2. Moderate or Discounted cashflow or Time value method.

# TRADITIONAL METHOD

A traditional Method are of again two types:

1. Pay back period method
2. Average/Accounting rate of return (ARR)

# 1. PAY BACK PERIOD METHOD

Pay back period or pay block period is the most widely used technique for project appraisal. In pay back period technique and cost.

In this method, we have to calculate cashflow, After tax before depreciation.

# 2.AVERAGE RATE OF RETURN

ARR is called as average rate of return. This method takes into accounts, the earning expected from the investment over their own life. According to this, we consider average cashflow (or) average profits taken as After tax and after depreciation.

**In other words, it establishes the relationship between average annual profits to the total investment.**

$$\text{ARR} = \frac{\text{Average cash inflows}}{\text{Average investment}} \times 100$$

# DISCOUNTED CASH FLOW METHOD

1. Net present value (NPV)
2. Internal rate return (IRR)
3. Profitability index (PI)

# 1.NET PRESENT VALUE

This method is a moderate method of evaluating investment procedures. This method takes into consideration, the time value of money and attempts to calculate the return on investment by introducing the factor of time element It recognises the fact that a rupee earned today is worth more than the same rupee earns tomorrow.

The net present value of all inflows & outflows on cash acquiring to entire life of the project.

Compute the present value of total investment outlay and the present value of cash flows with discount rate. The NPV of each project by subtracting the present value of the cash flows from the present value cash outflows After tax and before depreciation.

# 2.INTERNAL RATE OF RETURN

IRR method is also a modern technique of capital budgeting that takes into account of the time value of money. It is also known time adjusted rate of return or trail and error. IRR can be defined the rate of discount at which the present value of cash outflows.

**The IRR is defined as that rate of interest when we to discount the cash flows of an investment, reduces it’s NPV to 0.**

# 3.PROFITABILITY INDEX

It is also a time adjusted method of evaluating the investment proposals. Profitability Index or Benefit cost ratio. It is the relationship between present value of cash inflows and present value of cash outflows. The Profitability Index is also known as the Profit Investment Ratio (PIR) or the Value Investment Ratio (VIR).

# Thankyou