Financial management

Business

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Financial Management Instruction Capital budgeting is the process of identifying, analyzing and selecting investment projects whose returns are expected to extend beyond one year.

Purpose of capital budgets: Capital budgets are normally be prepared to cover the longer period than sales, production and resources, say three to five years. The main purpose of capital budget is to indicate he expenditure required to cover the project for the required time. Capital budgeting is favorable where project of more than one year is under consideration. It helps the management to know about the plans that are favorable for the organization. In shortly the main purpose of capital budgets is to plan for long terms projects.

Capital Project techniques:

When an organization is investing in a capital project then project appraisal is the first technique that is carried out by the organization. Following are some techniques that are used in investment appraisal of the project.

Return on Capital Employed (ROCE)

Probability Index

Pay back Method

Net Present value (NPV)

Capital Rationing

Internal rate of return (IRR)

Return on Capital Employed (ROCE): This is also known as accounting rate of return (ARR). Simply it means how much a business earns in relation to its investment.

ROCE = Average annual profit before interest and tax / Average capital employed.

The basic advantage of this technique is that ROCE is much simpler than other methods and can links with other accounts easily. But seeing as both side of coin ROCE also have some disadvantages like ROCE is not an absolute measure of the project life and timing of cash flow is not considered in this method.

Payback Method: The payback period is the time a project will take to pay back the money spent on it. It is based on expected cash flows and provides a measure of liquidity.

Payback Period: Initial Investment / Annual cash flows

As a concept payback is easily understood and calculated. It can improve investment condition but the main disadvantage of payback is that it ignores the returns after payback period.

Net Present value (NPV): NPV simply means that what is the value of future flows in current terms. It is considered to be a superior to most of other methods. It consider the time value of money and an absolute measure of return but it also have some disadvantages like it is difficult to calculate and difficult to explain to managers.

Internal rate of return (IRR): IRR represent the discount rate at which NPV of an investment is Zero. It represents the breakeven cost of capital. As other techniques IRR has also some advantages like it consider the time value of money and use cash flows rather than profits. The main benefit of the IRR is that it is in percentage therefore easily understood by the managers. But as other methods IRR has also some disadvantages like it is not absolute measure of probability and also complicated to calculate.

Cost of Capital valuation:

The cost of capital is the rate of return that the enterprise must pay to

satisfy the providers of funds, and if reflect the riskiness of providing funds. Valuation of cost of capital is depend upon is based upon these certain things.

Cost of Equity

Cost of Debt

Weighted Average Cost of capital (WACC)

Cost of Equity: Cost of Equity can be determined with the help of two different models. Dividend growth model (DVM) and Capital asset pricing model (CAPM).

DVM: Ke = D/Po where Ke = Shareholders required return

D = Dividend from year 1 to infinity, Po = Share price now.

CAPM: Required return = Risk free returns + Risk premium ; Rf + beta (Rm – Rf)

Cost of Debt: Cost of debt is based upon further two types. Cost of Redeemable debt and cost of Irredeemable debt.

Cost of Redeemable debt can be calculated as

MV = I/Kd ; Where I = annual interest starting in one year time.

MV = market price of loan note now. Kd = debt holder's required return.

And the cost of Redeemable debt can be calculated through interpolation method (IRR).

Weighted Average Cost of capital (WACC):

Ke [E/E+D] + Kd [D/D+E] (I – T)

Where; Ke = Cost of Equity (Figure calculated form above methods)

Kd = Cost of Debt (Figure calculated form above methods)

I = Interest cost; T = Ta

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