Capital project

Countries

In capital budgeting decisions there are certain variables present in the business industry that ought to be taken into account to ensure that the appropriate figures are utilized in the capital expenditure appraisal. In capital budgeting, the principle of the time value ofmoneyarises, which basically states that $1 today is much more worth than $1 next year. This is due to four key components, which are: inflation rate, the risk-free component, general risk premium and property-specific risk premium.

The general rise in prices occurring is an economy is an important component of the discount rate. The inflation is usually determined by measuring the Consumer Price Index, which is quarterly calculated by the United States Bureau of Labor Statistics. This comprises the first element, which comprises the discount rate as stated in the previous paragraph. There are a number of methods that can be adopted in determining the discount factor. One of them is the weighted average cost of capital that was used in the previous part.

There are also the capital asset pricing model and the dividend growth model that can be used for such facet. All the methods hold their advantages and disadvantages. Thus it is up to management good judgment on which is the best method to use. This is due to the fact that sometimes one method is more applicable and better than other technique depending on the situation at hand. Inflation is not only a key determinant of the time value of money principle. It is also a key player in the computation of the cost of capital determined for the capital project.

Sometimes during the determination of cash inflows and outflows stemming from the capital project, management erroneously does not consider inflation in such calculations. The absence of inflation leads the real cash flows to be equal to the actual money changing hands. However, when inflation is taken into account, which ought to be since it a real factor continuously present in the businessenvironment, the two variables mentioned above does not equal each other. In such instances a real discount factor rate is determined, which considers the inflation element.

The equation utilized in thisrespectis the following: In today’s business environment, predictions are increasingly unsure due to the fast changing variables in such environment. Therefore, the uncertainties of cash flows are always present irrelevant of which forecasting technique is used. An effective method that can be used in order to mitigate such uncertainty issue is a sensitivity analysis. This basically encompasses variation of the key factor values, which mainly consist of the cash inflows and outflows in order to portray a wider spectrum of the capital project’s effect.

The adoption of such method will therefore provide further financial information to management in order to aid them in their decision. Again judgment and attitude towards risk plays a critical part in such facet.

References: Brockington B. R. (1993). Financial Management. Sixth Edition. London: DP Publications. Drury C. (1996). Management and Cost Accounting. Fourth Edition. London: International Thomson Business Press. Lucey T. (1996). Quantitative Techniques. Fifth Edition. London: Ashford Colour Press.