

Capital budgeting evaluation techniques in the corporate business setting

[Business](#), [Accounting](#)



Abstract This paper will give a comparison between the various preferred capital budgeting evaluation techniques in the corporate business setting. There will be a recommendation given for the Guillermo Furniture Company based on the results of one or more evaluation techniques, which in turn will help direct the financial health of the organization.

Corporations are continually striving to improve the financial health of its organization and one strategic way many corporations are doing that is through capital budgeting. Capital budgeting involves choices. The choices revolve around projects that will add value to the organization. The projects can include acquiring land, purchasing a truck, or replacing old equipment. Many times, corporations are encouraged to undertake projects that will increase its profitability. The challenge is to find the appropriate evaluation method to bring the intended profitability into reality.

The three preferred evaluation methods that many corporations use are net present value, internal rate of return, and payback period. Many corporations often calculate capital budgeting solutions using all three methods. However, each method often produces contradictory results. The net present value method is the most accurate valuation approach to capital budgeting issues (small business). If a corporation can discount the after tax cash flow by the weighted average cost of capital, managers can determine if the project will be profitable or not.

The net present value method reveals exactly how profitable a project will be to the corporation versus the alternative methods (Chen, 2012). With the various evaluation methods, corporations can base the decisions for the

future on the results of the evaluation. The net present value method takes the time value of money by discounting an investment's future return to a present value (Chen, 2012). The thought behind the time value of money concept is that a dollar in hand today is worth more than the same dollar in the future.

In capital budgeting decisions, the net present value discount is taken into consideration when the present value of the future return is compared with the present value of the cash outflows on any investment (Mason, 2011). If a corporation, such as Guillermo Furniture, is considering using the net present value method, the return on the investment would show clearly whether it is more than sufficient to increase the financial health of the corporation or not. Another preferred evaluation method is the internal rate of return. The internal rate of return is a discount rate that results from a net present value equal to zero (Mason, 2011).

When the internal rate of return is higher than the weighted average cost of capital, it would be considered a profitable endeavor and thus should be pursued (Steven, 2010). A major advantage of the internal rate of return method is that it provides a benchmark for every project (Steven, 2010). This can allow a corporation to compare projects on the basis of the return on invested capital. For example, if Guillermo Furniture's internal rate of return results higher than the cost of capital, it would be determined that the project is acceptable, and the corporation should move forward on the project.

However, if the results are less than the cost of capital, the corporation should abort the project as it would hurt the financial health of the corporation. The final preferred evaluation method used by corporations is the payback period method. The payback period method reveals the amount of time it would take to recover the initial investment on a particular project (smallbusiness). Even though this method is considered preferred, it can result in disappointment for many corporations who value the results (Steven, 2010).

The main reason is the results do not factor in the cash flow in its entirety from a certain project, which can skew the overall result of the return on the potential investment (Steven, 2010). When a corporation analyzes this method, it is determined that it results in a break even measure and only measures the economic life of the particular investment revolving around the payback period (Steven, 2010). This method is used mainly as a comparative measure for the net present value and the internal rate of return giving a time frame of recovering the initial investment.

After considering the three preferred evaluation methods, it was determined that the net present value method would be the method of choice for the Guillermo Furniture scenario for a couple of reasons. First, the corporation cannot rely solely on the payback method because it does not take into account the entire cash flow for the project. After calculating how much time it would take to recover the initial investment, it was found that it would take more than 50 years, which is unrealistic for capital budgeting purposes. The focus shifted to the second preferred method of internal rate of return.

The internal rate of return proved that the return on the investment would only yield 10%. The calculation was based on taking the total investment of \$1,354,141.21 and dividing it on the number of years the profit was expected to continue, which totaled \$133,742.20. The expected rate of return for the project had to be at least 12% for the project to be acceptable. Based on the net present value calculations and taking the required rate of return of 12%, the number of years the profit is expected to continue, which is 5, and the future annual cash flows amount of \$26,748.4, the present value of future cash flows equaled \$96,422.14. The net present value is measured by taking the investment outflow (\$96,422.14) minus the present value of future cash flows (\$1,354,141.21), which equals \$1,257,719.07. By dividing this amount by the investment outflow, the rate of return on investment yields 13%. Therefore, it would be recommended that Guillermo Furniture use the net present value method for this project as it would improve the financial health of the corporation. References Chen, J. (2012). ADDING FLEXIBILITY FOR NPV METHOD IN CAPITAL BUDGETING. Global Conference on Business ; FinanceProceedings, 7(2), 49-56. Retrieved from EBSCO host Mason Jr, J. O. (2011). A Couple of Capital Budgeting Techniques using Microsoft Excel. Advances in Management, 4(4), 23-27. Retrieved from EBSCO host Steven, G. (2010). PERFORMANCE OPERATIONS. Financial Management (14719185), 38-42. Techniques in Capital Budgeting Decisions Retrievedwww. smallbusiness. chron. com/techniques-capital-budgeting-decisions-23638. html