

Capital budgeting process

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



Capital budgeting is the process of providing financial information in order to aid management in the selection of the long-term projects provided at hand (Eakins 2002, p 261). The Capital Budgeting Process comprises the following (Dayananda et al. 2002, pp 5-9):

Development of Strategic Plan and Corporate Goals: The strategic plan encompasses the overall plan of the organisation and outlines the business the company is in together with the position it envisages to achieve. This long-term plan can be considered as the yardstick of all the actions of the corporation including capital budgeting (Dayananda et al. 2002, p 5-6).

- Identify Investment Opportunities and Conduct a Preliminary Screening: Identification of investment opportunities is an area that requires substantial research in the capital budgeting system. Opportunities are not born on their own accord and management together with staff should strive hard in search of such factors (Dayananda et al. 2002, p 6). For example, prominent organisations like Intel and Sony spend considerable sums of money in research in order to provide the best products in the market. Therefore the absence of this important stage will basically perish the entire capital budgeting system, which is highly hazardous for the firm. Unless there are new opportunities to attain, the company will enter into a stalemate and shall be the shadow of its past. Such corporations normally end in their own demise.

Companies that meticulously search for investment opportunities do find them and attain competitive advantages and even market leadership. For example, Southwest Airlines was capable to attain market prominence in the airline industry in the United States. This was achieved by putting in practice

a marketing niche strategy in an opportunity identified of providing short-haul, frequent, low priced, point-to-point air travel (Hartley 2000, p 114-115). However, management should not be excessive on identification and evaluation of investment opportunities and must adopt a preliminary screening of the projects noted. This enhances efficiency by avoiding the company to spend much time in investment opportunities that are not good for the firm at hand (Dayananda et al. 2002, p 6-7).

Perform Capital Expenditure Appraisal in Financial Terms: A preliminary screening does not necessarily mean that management hold sufficient information to decide on the financial viability of the project at hand. Further substantial testing is necessary in order to decide on the optimal capital project in financial terms. This financial examination is considered in the next stage of the capital budgeting process.

Estimate of the Cost of the Project: The first element that should be considered in the determination of the costs of the project at hand is the opening expenditure incurred by the project. Such expenditure normally holds tangible fixed assets¹, like buildings and machinery. However, it is frequently the case in capital budgeting that additional investment in working capital is necessary. This arises from extra need of raw materials in the production process and higher trade debtors may also rise for the increasing volume of sales stemming from such project. Any increases in trade creditors also arising due to higher trade are deducted from the current asset² requirements noted above. This net increase in working capital is considered in the same manner as the initial capital expenditure occurring from the capital investment envisaged

Project Cash Flow Forecasts: This step entails forecasting the cash flow movements in the estimated period arising from the operations of the project. At this stage it is important to consider accounting income statements carefully because they contain both cash and non-cash transactions (depreciation), due to the accruals concept with which they. Therefore the cash flow forecast will consider incremental cash inflows and outflows³ together with capital costs noted in previous sub-section.

Projected Cash Flows Riskness Estimated: In practice, long-term cash flow estimates are very vulnerable and subject to unexpected economic and market movements leading to drastic changes in the cash flow position of the firm. Indeed uncertainty is a major element of capital budgeting that management should consider (Lucey 2003, p 458). Even though nowadays there are elaborate forecasting techniques, the incremental cash flows are still susceptible to change, which may alter the project's financial attractiveness.

Discounting of Projected Cash Flow Estimates: An important principle that should be applied in capital budgeting is the time-value of money. This encompasses that a \$1 now is worth more than \$1 in one year's time (Lucey 2003, p 414). This arises due to risk, inflation and opportunity cost. There are two main capital expenditure techniques that abide with the time value of money principle. These encompass the Net Present Value Method and the Internal Rate of Return (Lucey 2003, pp 415-416).

Determination of the Project Feasibility: Once all the incremental cash inflows and outflows from the project have been gathered and discounted it is time to see if the project is feasible or not. If the net present value, which

is the summation of the present value of net cash inflows/(outflows) and capital expenditure is positive, then the project is financially feasible. Under mutually exclusive projects, the capital project with the highest net present value is selected.

Consideration of Qualitative Factors: It is a fatal mistake if management evaluate the capital project solely on the grounds of quantitative variables. Qualitative elements should also be taken into account because they also affect the project and the financial wealth of the organisation. Qualitative elements are factors that cannot be examined in monetary terms, but which are also pertinent to the project at hand (Dayananda et al. 2002, p 7). For example, Toys ' R Us made the vital mistake with the introduction of toysrus.com scheme. This entailed the ordering of goods online by the company. Even though there was a drastic increase in sales the reputation of the organisation suffered tremendously because they were not able to meet the orders on a timely basis (Clark 2001).

Acceptance or Rejection of Project: such decision is based on the results gained from the aforesaid steps.

Implementation of Project once Accepted: This phase is very important because it ensures the efficiency and effectiveness of the project. With respect to the efficiency facet, management should acquire the necessary resources if not available in order to start the business operations. Such factors of production basically encompass the labour element and any other assets necessary for the commencement of the operations.

Monitoring and Control of Project: Apart from facilitating the implementation of the project, proper procedures should be put in place to monitor a smooth running of the firm's operations over the life of the project. Such monitoring aspect is very important at the beginning of the project. If done properly, it can be a useful tool in identifying potential bottlenecks at an early stage and thus further aid efficiency and effectiveness (Dayananda et al. 2002, p 8). An effective control measure that the firm can put in practice is the balanced scorecard.

Post-Implementation Audit: That latter factor of the capital budgeting system is fruitful for any proceeding capital budgets and does not affect the present capital project considered. This encompasses auditing the present capital project appraisal after being performed. The feedback that management attains from such exercise will aid in further strengthening the accuracy of future estimates and enhance the level of confidence in capital budgeting figures (Dayananda et al. 2002, p 8-9). For instance, if the previous capital projects conducted failed to increased shareholders' wealth as envisaged, management may for example consider the application of another forecasting technique. Therefore the last stage of the capital budgeting process is mainly aimed towards improving the effectiveness and accuracy of financial information conveyed in capital budgeting.

Importance of Cash Budgets for Dadley Corporation

Cash is a central element for the survival of an organization. Without it a company will perish in a short period. Indeed it is more important than the profitability of the organization. In the absence of profits, a company may survive a year or two. However, in a cash shortage the company will perish

in a few months, because the financial obligations stemming from short-term debt, long-term debt and operations will not be met. In this respect it is imperative that management plans in advance the cash inflows and outflows of the organization.

Such planning will enable management to see the cash position of the company and thus decide if there is any cash shortage, which has to be backed with short-term finance, like leases and short-term loans. If on the contrary, there is a cash surplus, such money can be invested to lead a return that enhances the financial performance of the firm. A cash budget is a useful medium through which management can undertake and document such planning.

Final Thought – Envisaged Cash Position of Dadley Corporation

In the second quarter it is envisaged that £305, 200 excess cash will be generated from operations. However, in May the firm will be required to borrow £90, 000 primarily due to significant capital expenditure undertaken in that month. Therefore the net surplus cash will amount to £215, 200. This is a positive figure, which outlines sound cash management for Dadley Corporation.

1 Tangible Fixed Assets also known as property, plant and equipment are resources held by the enterprise used in the production or supply of goods/services. The economic benefits derived from such assets exceed more than one accounting period.

2 Current assets encompass resources held for sale or consumption in the normal trading course of the firm and are expected to be realized within twelve months of the balance sheet date.

3 Only revenues and costs that are altered by project are considered as relevant. All other costs that remain the same irrespective of the decision are treated as sunk costs and omitted from capital expenditure appraisal (Lucey 2003, p 325).