

# [The meaning and importance of capital expenditure](https://assignbuster.com/the-meaning-and-importance-of-capital-expenditure/)

Expenditure means a payment made by a business to obtain some benefits, i. e., assets, goods and services (AINAPURE, varsha and ainapure, mukund, 2009).

## 1. 2 Meaning of Capital Expenditure or Asset

Capital expenditure is that expenditure which is for future benefits. It means expenditure for gaining an asset. Asset is a resource controlled by an organization as a result of past event and for which future benefits are expected (AINAPURE, varsha and ainapure, mukund, 2009).

## 2. Revenue expenditure

## 2. 1 Meaning of revenue expenditure

Revenue expenditure are expenditures for ordinate repairs, maintain ace, fuel , insurance or other item needed to maintain used building, and plant and equipment. They go to the expense account and reduce the income of period in which they are incurred, because benefits from these expenditures don’t last beyond that period (NARAYANASWAMY, R, 2008).

## 3. Differentiate between Capital and revenue Expenditure

## Investment Appraisal

## What is an investment?

Specifically, an investment is the current commitment of dollars for a period of time in order to derive future payments that will compensate the investor for (1) the time the funds are committed, (2) the expected rate of inflation, and (3) the uncertainty of the future payments(BROWN, Keith and Reilley, Frank, 2005).

## Method of investment Appraisal

A company’s shareholders prefer to be rich rather than poor. Therefore, they want the firm to invest in every project that is worth more than it costs. The difference between a project’s value and its cost is termed the net present value. Companies can best help their shareholders by investing in projects with a positive net present value (BREALEY et al., 2001).

We start this material by showing how to calculate the net present value of a simple investment project. We also examine other criteria that companies sometimes consider when evaluating investments, such as the

NPV

project’s payback period

IRR

## Net Present Value (NPV)

Suppose that you are in the real estate business. You are considering construction of an office block. The land would cost $50, 000 and construction would cost a further $300, 000. You foresee a shortage of office space and predict that a year from now you will be able to sell the building for $400, 000. Thus you would be investing $350, 000 now in the expectation of realizing $400, 000 at the end of the year. You should go ahead if the present value of the $400, 000 payoff is greater than the investment of $350, 000. Assume for the moment that the $400, 000 payoff is a sure thing. How much would you have to invest in it in order to receive $400, 000 at the end of the year (BREALEY et al., 2001).

That’s easy: you would have to invest

## $400, 000 Ã- 1/1. 07 = $400, 000 Ã- . 935 = $373, 832

Therefore, at an interest rate of 7 percept, the present value of the $400, 000 payoff from the office building is $373, 832.

## NPV = PV – required investment

## = $373, 832 – $350, 000 = $23, 832

In other words, your office development is worth more than it costs-it makes a net contribution to value.

## Internal Rate of Return

Instead of calculating a project’s net present value, companies often prefer to ask whether the project’s return is higher or lower than the opportunity cost of capital. For example, think back to the original proposal to build the office block. You planned to invest $350, 000 to get back a cash flow of C1 = $400, 000 in 1 year. Therefore, you forecasted a profit on the venture of $400, 000 – $350, 000 = $50, 000 (BREALEY et al., 2001).

## Rate of return = profit/ investment

## = C1 – investment/ investment = $400, 000 – $350, 000/ $350, 000

## = . 1429, or about 14. 3%

The alternative of investing in a U. S. Treasury bill would provide a return of only 7 percept. Thus the return on your office building is higher than the opportunity cost of capital.

This suggests two rules for deciding whether to go ahead with an investment project:

1.” The NPV rule. Invest in any project that has a positive NPV when its cash flows are discounted at the opportunity cost of capital.

2. The rate of return rule. Invest in any project offering a rate of return that is higher than the opportunity cost of capital” (BREALEY et al., 2001).

## PAYBACK PERIOD

These days almost all large companies use discounted cash flow in some form, but sometimes they use it in combination with other theoretically inappropriate measures of performance (BREALEY et al., 2001).

## Inflation and capital investment decisions

Inflation can have a serious effect on capital investment decisions, both by reducing the real value of future cash flows and by increasing their uncertainty. Future cash flows must be adjusted to take account of any expected inflation in the prices of goods services in order to express them in normal (or money) terms, i. e. in term of actual cash amounts to be received or paid in the future. As an alternative to the nominal approach to dealing with inflation in investment appraisal, it is possible to deflate nominal cash flows by the general rate of inflation in order to obtain cash flows expressed in real terms, i. e. with inflation stripped out (WATSON, Denzil and Head, Antony, 2010).

## (1+real cost of capital) = (1+ normal cost of capital) / (1+ inflation rate)

For example if the nominal cost of capital is 15% and the rate of inflation is 9 %, the real cost of capital will be 5. 5 %.

## Investment appraisal and risk involved

In the context of investment appraisals, risk refers to the business risk of an investment, which since it derives from a company’s capital structure is reflected in its weighted average cost of capital. Risk is tusk distinct from uncertainty, which increases proportionality with project life. A risk-averse company is concerned about the possibility of expected, i. e. with downside risk, and will therefore want to asses the risk of an investment project. There are several methods of assessing project risk and of incorporating risk into the decision making (WATSON, Denzil and Head, Antony, 2010).

## Sensitivity Analysis

Sensitivity analysis is a way of assessing the risk of an investment project by evaluating how responsive the NPV of the project is to change in the variables from which it has been calculated (WATSON, Denzil and Head, Antony, 2010).

## Types of risk

## Credit Risk

## Market risk

## Equity Risk

## Liquidity risk

## Financial Analysis

## Financial performance analysis using financial ratio

## Categories of Financial Ratios

Analysts find it useful to classify ratios into broad groupings, based on the characteristics that particular ratios are intended to measure. In this section, we discuss ratios under four major headings that are widely employed by analysts: liquidity, profitability, capital structure, and investor ratio (STICE et al., 2002).

## Liquidity Ratios

Liquidity ratios indicate the short-term solvency of the firm. They also indicate how effectively the firm is managing its working capital (STICE et al., 2002).

## Profitability Ratios

Profitability ratios are the second major focus of analysis for any investor. Without profits, there will be no return to the investor or no one will want to invest (STICE et al., 2002).

## Gross Profit

The gross profit percentage is the first source of profitability for a manufacturing or merchandising firm. The data for the gross profit margin are found in the first sections of the income statement. These data indicate the level of profits earned from buying and reselling goods (STICE et al., 2002).

## Operating income ratio

The operating income ratio is the second indicator of profitability because it includes

All the other normal and recurring operating costs. Increasing or stable levels

Of operating income indicate sustainability of the firm’s profits (STICE et al., 2002).

## Financial Statement Analysis, Wendy’s International, Inc.

In this section, we apply our financial statement analysis framework to Wendy’s International, Inc.

## Liquidity Analysis

## Profitability Analysis

## Summary, Wendy’s International, Inc.

Our analysis of Wendy’s financial statements is cautiously positive. The primary weak indicator is in the area of profitability (based on accrual-based earnings), and this result may be due to transitory effects that may not persist in the future. There were significant positive trends in liquidity, and stability in investor ratios. Further examination of supplementary information, as well as subsequent quarterly results for 1998 and 1999, could be used to support or challenge these conclusions (STICE et al., 2002).

## Non-Financial Analysis Using Balance score card

## Balance Score Card

The Balanced Scorecard (BSC) is a technique developed by Kaplan and Norton (1992) that helps organisational decision makers to navigate the organisation towards success. The technique enables organisations to translate their mission and strategy into a comprehensive set of performance measures that provide the framework for a strategic measurement and management system. Organisations have used the Balanced Scorecard to; (1) clarify and translate vision and strategy, (2) communicate and link strategic objectives and measures, (3) plan, set targets and align strategic initiatives and (4) enhance strategic feedback and learning, and succeed in realizing both tangible and intangible benefits of their investments (Kaplan and Norton, 1992, 1996, 2000).

The Balanced Scorecard measures organisational performance, with emphasis on financial objectives. But, it also includes the performance drivers of these financial objectives, and measures organisational performance across four balanced perspectives; (1) financial, (2) customer, (3) internal business processes and (4) learning and growth (DARSHANA SEDERA, Guy Gable and Michael Rosemann).

## Framework of Balance Score Card.