

Course: BBA Part II
Paper: XII
Topic: Concept of Capital Budgeting
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Concept of Capital Budgeting

Capital budgeting is a planning process that is used to determine the worth of long-term investments of an organization. The long-term investments of the organization can be made in purchasing a new machinery, plant, and technology.

In other words, capital budgeting is a method of identifying, evaluating, and selecting long-term investments. The concept of capital budgeting has a great importance in project selection as it helps in planning capital required for completing long-term projects. Selection of a project is a major investment decision for an organization.

Therefore, capital budgeting decisions are included in the selection of a project. In addition, capital budgeting helps in estimating costs and benefits involved in a particular project. A project is not worth investing, if it does not yield adequate return on invested capital.

The significance of capital budgeting is explained in the following points:

(a) Long-term Applications:

Implies that capital budgeting decisions are helpful for an organization in the long run as these decisions have a direct impact on the cost structure and future prospects of the organization. In addition, these decisions affect the organization's growth rate.

Therefore, an organization needs to be careful while making capital decisions as any wrong decision can prove to be fatal for the organization. For example, over-investment in various assets can

cause shortage of capital to the organization, whereas insufficient investments may hamper the growth of the organization.

(b) Competitive Position of an Organization:

Refers to the fact that an organization can plan its investment in various fixed assets through capital budgeting. In addition, capital investment decisions help the organization to determine its profits in future. All these decisions of the organization have a major impact on the competitive position of an organization.

(c) Cash Forecasting:

Implies that an organization needs a large amount of funds for its investment decisions. With the help of capital budgeting, an organization is aware of the required amount of cash, thus, ensures the availability of cash at the right time. This further helps the organization to achieve its long-term goals without any difficulty.

(d) Maximization of Wealth:

Refers to the fact that the long-term investment decisions of an organization helps in safeguarding the interest of shareholders in the organization. If an organization has invested in a planned manner, shareholders would also be keen to invest in the organization. This helps in maximizing the wealth of the organization. Capital budgeting helps an organization in many ways. Thus, an organization needs to take into consideration various aspects.