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Significance of Capital Budgeting on Managerial Accounting

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Abstract*: The purpose of this paper is to highlight those topics of managerial accounting that have been affected by the capital budgeting decisions. which has been published in management accounting research journals; discover what capital budgeting methods have been most commonly used; and identify methods that have been infrequently used. This is a descriptive research study that explores the significance of various methods used in capital budgeting and how it affects the managerial decision.*

Keywords: managerial accounting

I. INTRODUCTION

Capital budgeting is an accounting principle using which companies decide whether to invest in a particular project, as all the investment possibilities may not be rewarding. Companies use capital budgeting to generate a quantitative overview of each asset and investment, and it provides a rational ground for making a judgment or forming an opinion. Learning about various capital budgeting methods can help you understand the decision-making processes that companies and investors employ. In this article, we examine what is capital budgeting and why is it important, apart from explore the various budgeting methods available.

Objectives of Capital Budgeting

1. Selecting profitable projects
2. Capital expenditure control
3. Finding the right sources for funds

Selecting profitable projects

An organization comes across various profitable projects frequently. But due to capital restrictions, an organization needs to select the right mix of profitable projects that will increase its shareholders' wealth.

Capital expenditure control

Selecting the most profitable investment is the main objective of capital budgeting. However, controlling capital costs is also an important objective. Forecasting capital expenditure requirements and budgeting for it, and ensuring no investment opportunities are lost is the crux of budgeting.

Finding the right sources for funds

Determining the quantum of funds and the sources for procuring them is another important objective of capital budgeting. Finding the balance between the cost of borrowing and returns on investment is an important goal of Capital Budgeting.

Capital Budgeting Techniques

To assist the organization in selecting the best investment there are various techniques available based on the comparison of cash inflows and outflows. These techniques are:

Payback period method

In this technique, the entity calculates the time period required to earn the initial investment of the project or investment. The project or investment with the shortest duration is opted for.

Net Present value

The net present value is calculated by taking the difference between the *present value of cash inflows* and the *present value of cash outflows* over a period of time. The investment with a positive NPV will be considered. In case there are multiple projects, the project with a higher NPV is more likely to be selected.

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Accounting Rate of Return

In this technique, the total net income of the investment is divided by the initial or average investment to derive at the most profitable investment.

Internal Rate of Return (IRR)

For NPV computation a discount rate is used. IRR is the rate at which the NPV becomes zero. The project with higher IRR is usually selected.

Profitability Index

Profitability Index is the ratio of the present value of future cash flows of the project to the initial investment required for the project. Each technique comes with inherent advantages and disadvantages. An organization needs to use the best-suited technique to assist it in budgeting. It can also select different techniques and compare the results to derive at the best profitable projects.

Recent studies highlight that financial managers worldwide favor methods such as the internal rate of return (IRR) or non-discounted payback period (PP) models over the net present value (NPV), which is the model academics consider superior. In particular this research focused on small, medium and large businesses and investigated a number of variables and associations relating to capital budgeting practices in businesses in the Western Cape province of South Africa. The results revealed that payback period, followed by net present value, appears to be the most used method across the different sizes and sectors of business. It was also found that 64% of businesses surveyed used only one technique, while 32% of the respondents used between two to three different types of techniques to evaluate capital budgeting decisions. The findings show that the more complicated methods such as IRR and NPV are most favored by the large businesses as compared to the small businesses. The majority of the respondents believed that project definition was the most important stage in the capital budgeting process. Implementation stage appeared to be the most difficult stage for the manufacturing sector whereas Project definition, Analysis and selection and Implementation were generally rated as being the difficult stages by the retail sector. Project definition and Analysis and selection were found to be the most difficult stages by the service sector. Most businesses used the cost of bank loan as a basis in capital budgeting and more than two thirds of respondents used non quantitative techniques to consider risk when making a decision on investing in fixed assets.

II. CONCLUSION

Financial planning determines how much money to spend and where based on the available funds. Capital Budgeting aids in ensuring that finances are public when they are needed. It also ensures that the company does not waste resources by raising them. Financial planning aids in collecting optimal funds, properly investing funds, establishing an adequate capital structure, establishing a link between investment and financial decisions, and avoiding business surprises and shocks.

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