

INTERNATIONAL JOURNAL OF LAW
MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 5 | Issue 3

2022

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The Impact of Capital Budgeting in the Private Sector

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ABSTRACT

The following research paper focuses on explaining the concept of capital budgeting. The meaning, enhancements and aspects related to the concept and how it is one of the most important aspect for the private sector. It initially explains the basic definitions and meaning of terminologies involved in the spotlight and its interpretation. Furthermore, the paper tries to analyse the various ways in which capital budgeting is important for the overall development of the private sector. Like all the other concepts of economics and corporate laws, this also has certain drawback which are states in detail followed by the techniques and methodologies that should be used by the companies or are usually used for the said purpose. Subsequently, the impact of covid 19 on the whole issue is also studied in brief. In conclusion the research paper explains how capital budgeting is more or less a gamble as future endeavours can never be predicted in the light of the recent shutting down of various companies because of the covid 19 pandemic.

I. INTRODUCTION

Every company, to gain profits must spend some capital so that the goods and services can be produced. The most feasible way followed by almost all the business firms is budgeting their capital. Budgeting is something which can be seen in every household, small business, large business, enterprise. It is a way by which people manage their expenditure. In case of a business enterprise, the most important and the sole aim is to gain profits and minimize their expenditure. This is something very close to the concept of equilibrium as explained in economics. Therefore, Capital budgeting can be defined as a long-term monetary plan laid down by a company which is needed for the company to buy such assets that would help in production of goods and services.

Capital budgeting is a plan which does not last only for 1 or 2 years. It is usually a multi-year plan which makes is long term. This long duration helps the company or enterprise in saving their financial capital in such a way that once the period of budgeting gets finished, the company has enough to execute its expenditure. As far as the historical background is

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concerned then the concept of capital budgeting incepted in the USA mostly on a large scale after the second world war. The world had already gone through a political, social, societal, and financial crisis. In such circumstances, it was important for the already existing businesses to formulate a proper planning mechanism by which the capital needed to run a business and earn profits could be generated. This whole multi year plan is usually 5- 10 years long as it holds a huge impact on all the entities involved in the business including the stakeholders. The main work of this plan after the stipulated time frame for planning is over is providing a company with such a set patter of financial resources which should be used to manage the future expenses of the business as well as gain benefits and profits. Basically, it deals with the allocation of those resources of a company that are scarce, keeping the mind, the kind of opportunities the market offers at that point of time. However, a major point to be notes here is as the budget currently in operation and the budget that must be planned for future allocations, i.e., the operating budget and the capital budget are two different concepts and must not be interlinked as one is used for the ongoing expenditure of the business because for all obvious reasons, a business cannot wait for 5-10 years till the time enough funds can be generated for future purposes. Capital budgeting is long term whereas the former deals with day-to-day expenses. Capital budgeting helps in analyzing the future prospects and profits that a project might offer and how close or far those profits would be to the expenditure incurred by the company/business for the said project.

II. CHARATERSTICS OF CAPITAL BUDGETING

1. Future investment: the only thing common in capital budgeting and operating budget is that both require the use of presently available funds of the company or business. Under the concept of capital budgeting, these presently available funds are used for the future.
2. The money that is invested for long term purposes.
3. Another important aspect is that once a company decided to invest in long term plan of 5-10 years then this decision cannot be revoked and the company shall have to make it till the end of the period for profits that it might gain in future.
4. The funds involved in the process of capital budgeting are usually of a huge amount as they are invested for a longer period of time for a future use.

Capital budgeting is important for various purposes. For example, if we take the last point mentioned above under the characteristics, i.e., huge amount of fund. A company has scarce resources that will not last forever or a long period for that purpose. Therefore, the best decision that a company can make under such circumstances is that of investing money in future projects

which would help the company by giving it future benefits even If these scarce resources cause loss to the business, it will still have the hope of benefits from the investments it had made for future benefits. Moreover, if there are several factors that work in favor of capital budgeting, there are some factors contrary to it. These are as follows:

1. Once the company or business decides to invest its capital for long term purposes then it must stick to the decision for a long period. It leaves no room for them to change their minds.
2. Sometimes, this rigid nature of the budgeting also causes the company a massive financial crisis because not only the investment is of a large amount, but it is also constant.
3. Investing capital for future purposes is directly proportional to uncertainty because one can never predict the market propositions or condition in the future. There is a possibility of losses rather than profits.
4. Just for instance, a company takes wrong decision capital budgeting, per say, wrong technique of investment or incorrect planning can cause a huge setback to the company in terms of money and the company's durability can be put into jeopardy.

III. TYPES OF CAPITAL BUDGETING

Long term investment is made by a company for various purposes that would help the whole enterprise or business to grow. These types are as follows:

1. **Replacement-** in a company there comes a situation when the assets or equipment get damaged or wear out. In such situations an investment must be made because worn out assets require an increased investment as they have to be mended again and again. Therefore, the one-time investment, though of a huge amount should be made by the company so that the regular expense of mending assets comes to an end. Moreover, mended and properly working equipment help in reducing the overall maintenance expenditure of the company. This is where capital budgeting helps the company in gaining a profit by only paying one time to maintain the equipment and increasing their efficacy.
2. **Environment Friendly-** every country has their respective norms as far as the environment is considered. These industries and companies of all types that produce good and services also emit a lot of gasses and environmentally hazardous chemicals. therefore, a company must invest to the adherence of environment norms, insurance

and other compulsory investments. These, however, do not help in generating any profits or revenue for the company.

3. **Other**- expenditure for a company in itself is uncertain and cannot be predicted. Some expenses arise on the spot, for example, some kind of loss, packaging related expenses, construction in the office building.

IV. APPROPRIATE METHODOLOGY FOR CAPITAL BUDGETING

For every company investment is a must for growth but it is even more important that such investments are not made without a properly laid down plan, method, or layout. Some of these methodologies are as follows:

1. **NVP**- the NVP or the net value present method is a concept which can be the most helpful for a company. Future can never be certain but can be analyzed based on the present conditions. Therefore, under his method the company analyses its present inflow and outflow of cash and derives the difference between the two. In short, this method helps in analyzing the profit margin of the company. In this way, the company tries to predict what the future inflows and profitability ratio might be or look like. But it is obvious that there is no reliability of the method but can be used in analysis.
2. **Accounting rate**- another method by which budgeting can take place is by the rate of return. For example, A is a company planning to invest 10 lakhs on a future project which is predicted to yield profits, but the company wants to gain surety and for this purpose, they decide to estimate the total profit and revenue that the company will acquire by investing in the project. After analyzing the revenue expected, the company calculates the total amount that they will spend for the purpose of this project. Thereafter, the profit is predicted, in this manner, company A plans capital budgeting.
3. **P.I.**- P.I. or profitability index is another method of capital budgeting. In this method the company ranks the project in an ascending order in terms of the profits that it incurs.

V. IMPACT OF COVID 19 ON CAPITAL INVESTMENT

The pandemic has caused severe financial crisis almost all the companies in some or the other way, due to decreased sale, production and management of goods and services, various companies have incurred huge losses. This surely lowers down the investing powers of the companies causing a nationwide slowdown in the market because as universally known, markets only operate on liquidity and once expenditure and cash flow slows down, it brings in losses for many. Therefore, insufficient investing power has caused various companies to shed off its employees as an attempt of cost cutting and lowering the already existing expenditure

which is impossible to get rid of. If we talk about the market in 2016-2019 then we will come across the fact that in 2020 the market totally dropped. In this span, there might obviously be several countries to have invested their money in long term projects. However, just as mentioned earlier in the paper, future can never be predicted, it was proven true this time as well. The pandemic has caused such severe losses to such companies already paying huge amounts regularly as part of their capital budgeting and most of them have shut down.

VI. CONCLUSION

The research paper concludes that capital budgeting is the most important aspect for a company's growth but at the same time, it holds a lot of risk and involves major concerns like the one faced by various companies during the covid 19 pandemic. This can be termed as gamble that allows no bargaining, the companies either take a part and invest capital or count themselves out of the race of growth. Therefore, there should be a proper planning by all the companies before making any investment in a said future project keeping in mind all the aspects and occurrences which might take place in the future, in cases like the pandemic hitting the world, even the techniques of capital budgeting could not help the companies. Therefore, it is on the investing power and the intensity of setback and losses a company can resist in case of future hurdles to the projects they have been investing in.
