

➤ **Important Aspects of Capital Budgeting Process are**

- **Identification** of investment ideas is the most critical aspect of the investment process, and should be guided by the overall strategic considerations of a firm. It needs appropriate managerial focus. Each potential idea should be developed into a project.
- **Development** A company should have systems for estimating cash flows of projects. A multi-disciplinary team of managers should be assigned the task of developing cash flow estimates.
- **Evaluation** Once cash flows have been estimated, projects should be evaluated to determine their profitability. Evaluation criteria chosen should correctly rank the projects.
- **Authorisation** Once the projects have been selected they should be monitored and controlled to ensure that they are properly implemented and estimates are realised. Proper authority should exist for capital spending. The top management may supervise critical projects involving large sums of money. The capital spending authority may be delegated subject to adequate control and accountability.

- **Control** A company should have a sound capital budgeting and reporting system for this purpose. Based on the comparison of actual and expected performance, projects should be reappraised and remedial action should be taken.

Companies are increasingly using DCF techniques, but payback remains universally popular for its simplicity and focus on recovery of funds and liquidity. In practice, judgement and qualitative factors also play an important role in investment analysis. A number of companies pay more attention to strategy in the overall selection of projects.

- **Strategic Investments Decisions** are large-scale expansion or diversification projects, and they involve either by their nature or by managerial actions valuable options. Such options include right to expand, right to abandon, right to delay, right to build new businesses, or right to disinvest or harvest.
- **Real Options** create managerial flexibility and commitment. In principle, they can be valued in the same way as financial options are valued. But in practice, it is difficult to get all input parameters for valuing real options. Since large numbers of real assets are not traded in the market, it is quite difficult therefore

to get information on the value of the underlying assets and the volatility. Since real options are valuable, managers must identify them, value them, monitor them and exercise them when it is optimal to do so. Managers generally strive to create flexibility and commitment by building real options into investment projects.