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CORPORATE FINANCE AND CAPITAL BUDGETING DECISIONS

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ABOUT ARTICLE

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Abstract: This paper explores the significance of capital budgeting methods in corporate finance and their role in optimizing investment decisions to maximize shareholder value and enhance organizational performance. Through a comprehensive review of existing literature and empirical analysis, this study examines various capital budgeting techniques, including traditional methods like payback period and accounting rate of return, alongside modern approaches such as net present value (NPV), internal rate of return (IRR), and real options analysis. The research investigates the strengths, limitations, and practical implications of each method in different business contexts, considering factors such as risk, uncertainty, flexibility, and strategic alignment. Furthermore, the thesis evaluates the impact of technological advancements, regulatory changes, and market dynamics on the adoption and effectiveness of capital budgeting practices in contemporary corporate environments. The goal of this study is to improve financial decision-making processes and, eventually, the competitiveness and sustainable growth of contemporary businesses by illuminating the changing environment of capital budgeting and providing insights into best practices.

INTRODUCTION

Corporate finance encompasses the management of funds within corporations, involving decisions related to capital structure, investment strategies, and financial risk management. Capital budgeting, a crucial aspect of corporate finance, refers to the process of evaluating and selecting long-term investment projects that involve significant capital outlays. It involves analyzing potential investment

opportunities, estimating their future cash flows, assessing risks, and determining their viability and alignment with the company's strategic objectives.

Capital budgeting is important in corporate finance for several reasons:

1. **Allocation of Resources:** Allocating scarce financial resources refers to the process of deciding how to distribute limited financial resources among different investment projects or opportunities. This process involves evaluating different investment options based on their potential returns, risks, and other relevant factors. The goal of this process is to identify the investment projects that offer the highest potential returns while minimizing the risks associated with those investments. By doing so, companies can maximize their shareholder wealth, which refers to the value that a company creates for its shareholders. In other words, by investing in projects that offer higher returns, companies can generate more profits and increase the value of their stocks, which ultimately benefits their shareholders.
2. **Long-Term Planning:** By focusing on long-term investment decisions, capital budgeting facilitates strategic planning and ensures the sustainability and growth of the company. By carefully considering the costs and benefits of different investment options, companies can make informed decisions about where to allocate their resources and how to prioritize their investments. This strategic planning approach helps companies to achieve their long-term goals and maintain their competitive edge in the market.
3. **Risk Management:** Through rigorous analysis of risks associated with investment projects, capital budgeting enables companies to mitigate risks and make informed decisions to safeguard their financial health. Through this analysis, companies can determine the potential return on investment and make informed decisions about whether to proceed with the project. This process is essential for companies to safeguard their financial health by ensuring that they are investing their resources in the most profitable and low-risk projects. By using capital budgeting, companies can mitigate the risks associated with investment projects and make informed decisions that are aligned with their long-term financial goals.
4. **Optimal Financing:** Effective capital budgeting assists in determining the optimal mix of debt and equity financing for investment projects, balancing the cost of capital and financial risk. Effective capital budgeting assists in determining the optimal mix of debt and equity financing for investment projects, balancing the cost of capital and financial risk. This involves balancing the cost of capital (i.e., the cost of borrowing money) with the financial risk associated with taking on debt. By finding the right balance between these factors, companies can ensure that they are making the most efficient use of their available resources and maximizing their potential returns.

Research

In this section, several key capital budgeting methods which can be fundamental to implement good corporate will be outlined one by one.

1. Payback Period:

- Payback period calculates the time required for an investment to recoup its initial cost through cash inflows. Payback period will be the best indicator when investor's priority is the period when cash flows cover initial investment.

- Example: If a project costs \$100,000 and generates annual cash flows of \$30,000, the payback period would be approximately 3.33 years (\$100,000 / \$30,000).

2. Net Present Value (NPV):

- NPV calculates the present value of future cash flows discounted at the project's cost of capital. NPV is important for project valuation, decision-making. According its NPV projects can be divided into 2 groups.

- **Mutually Exclusive Projects:** Choosing one project means rejecting others. The project with the highest NPV is selected.
- **Independent Projects:** Each project is evaluated on its own NPV. All projects with positive NPV may be accepted.

1st graph. The formula of Net Present Value

$$NPV = \sum_{i=1}^n \frac{CF_i}{(1+r)^i} - IC$$

- Example: If a project requires an initial investment of \$200,000 and generates annual cash flows of \$50,000 for five years, discounted at 10%, the NPV would be calculated by discounting each cash flow and subtracting the initial investment.

3. Internal Rate of Return (IRR):

- IRR is the discount rate that makes the NPV of an investment zero, representing the project's expected rate of return. IRR is important for evaluating investment projects, aiding decision-making, guiding resource allocation, and assessing risk in capital budgeting.

- Example: If a project's cash flows result in an NPV of zero at a discount rate of 12%, then 12% is the project's IRR.

4. Profitability Index (PI):

- PI compares the present value of future cash flows to the initial investment. The profitability index (PI) is important for evaluating investment projects, prioritizing resource allocation, comparing proposals, aiding decision-making, and managing risk effectively.

- Example: If the present value of cash flows from a project is \$300,000 and the initial investment is \$250,000, the PI would be 1.2 (\$300,000 / \$250,000).

CONCLUSION

In conclusion, making capital budget method can hugely boost the financial portfolio of the company by having numerous facilities like allocation of resources where investor can allocate its financial resources wisely that would gain much profit in the future, also by having diversification which means

to invest in different financial securities investor can mitigate risks considerably. Capital budgeting methods are payback period, NPV, IRR, Profitability index which help money allocators to be aware of how much time it takes to cover the initial investment, how profitable the investment can be and the value of return from investment and, especially, overall whether the investment would be applicable to make or vice versa.

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