Pre-requisites of Capital Budgeting:

Some of the most important pre-requisites of capital budgeting of any organization are as follows:

(a) Determining Capital Expenditure (b) Determining the Planning Period (c) Selecting Decision Rules (d) Collecting Data (e) Growth of the Organization (f) Risks (g) Irreversibility of Investment Decisions.

Capital budgeting is an essential process of any organization that helps to analyze, evaluate, and select the most lucrative investment project. Therefore, an organization needs to take into consideration various aspects before undergoing the process of capital budgeting.

Some of the important pre-requisites of capital budgeting is as follows:

(a) Determining Capital Expenditure:

Refers to the fact that capital plays an important role in selecting any investment project. An organization needs to define its total capital expenditure for purchasing various fixed assets. In capital budgeting, only long-term capital expenditure is taken into account, which is not adjustable in long term, whereas short-term capital expenditures, such as inventories and receivables, are not considered.

However, the long-term capital expenditures of an organization vary with projects of different time durations. Usually, capital expenditures having a duration of one year are taken into account for capital budgeting.

An ideal long-term capital expenditure involves the following:

i. New capital equipment ii. Long-term assets iii. Expansion or diversification of assets iv. Replacement expenditure v. Advertisement expenditure vi. Research and development expenditure

(b) Determining the Planning Period:

Refers to one of the most important aspects of capital budgeting. The duration of any capital expenditure include a high degree of risks. Therefore, an organization needs to clearly define the planning period of capital expenditure.

A well-defined period of capital expenditure is necessary for the following purposes:

i. Performing various operative functions, such as planning, executing, and controlling

ii. Merging new plans with old ones for the growth and development of the organization

iii. Assessing the size of plant and economies of scale

iv. Acquiring funds on time and managing finance of the organization

(c) Selecting Decision Rules:
Refers to the condition required for accepting or rejecting a project. Decision rules are generally selected on the basis of goals of an organization, such as profit maximization and minimization of cost. Therefore, before deciding criteria for decision rule, it is required to define the objectives of investment and then selecting criteria for the evaluation of project.

The following methods are used for evaluating projects: i. Payback period

ii. Net present value iii. Internal rate of return

After that, two approaches are used for final selection of a project, which are as follows:
(i) Accept-reject Approach:
Refers to a method of selecting a project used in case of limited amount of funds and when the selection is among limited projects.

(ii) Ranking Approach:
Refers to another technique of selecting a project when the amount of fund is huge and projects are available in a large number. In such a case, projects are ranked for investment according to their significance.

(d) Collecting Data:
Signifies an essential aspect of capital budgeting. An organization needs to collect relevant, accurate, and sufficient amount of data to make the capital budgeting process successful.

An accurate data helps in the following ways:

i. Determining different investment opportunities

ii. Assessing the cost associated with investment

iii. Calculating the expected rate of return from investment

iv. Knowing the productive life of project

v. Becoming aware of the rate of interest in market

vi. Ensuring the availability of funds

Apart from aforementioned pre-requisites, an organization needs to consider the following aspects:

(e) Growth of the Organization:

Implies that an organization needs to select project after considering its overall profit and market share. This is because of the reason that any wrong decision regarding project selection can affect the profitability of the organization. The growth of the organization can only be ensured, if it invests in appropriate projects.

(f) Risks:

Signify that uncertainties, such as economic recession, inflation, and change in technology, should be taken in account by an organization during the selection of a project. These risks may affect the profitability of the project to a large extent, which, in turn, hampers the growth of the organization.

(g) Irreversibility of Investment Decisions:

Refers to the fact that an organization cannot change or withdraw its investment decisions taken once, as it may cause financial losses. Moreover, changing the investment decisions may affect the goodwill of the organization. Therefore, the organization should be careful, while making project selection decisions. An organization requires an adequate amount of funds for capital budgeting. It can acquire funds from various sources.