Capital budgeting involves choosing projects that add value to a company. The capital budgeting process can involve almost anything including acquiring land or purchasing fixed assets like a new truck or machinery. Corporations are typically required, or at least recommended, to undertake those projects which will increase profitability and thus enhance shareholders' wealth.
However, what rate of return is deemed acceptable or unacceptable is influenced by other factors that are specific to the company as well as the project. For example, a social or charitable project is often not approved based on the rate of return, but more on the desire of a business to foster goodwill and contribute back to its community.

KEY TAKEAWAYS:

- Capital budgeting is the process by which investors determine the value of a potential investment project.
- The three most common approaches to project selection are payback period (PB), internal rate of return (IRR) and net present value (NPV).
- The payback period determines how long it would take a company to see enough in cash flows to recover the original investment.
- The internal rate of return is the expected return on a project. If the rate is higher than the cost of capital, it's a good project. If not, then it's not.
- The net present value shows how profitable a project will be versus alternatives, and is perhaps the most effective of the three methods.

Understanding Capital Budgeting:

Capital budgeting is important because it creates accountability and measurability. Any business that seeks to invest its resources in a project, without understanding the risks and returns involved, would be held as irresponsible by its owners or shareholders. Furthermore, if a business has no way of measuring the effectiveness of its investment decisions, chances are that the business will have little chance of surviving in the competitive marketplace.
Businesses (aside from non-profits) exist to earn profits. The capital budgeting process is a measurable way for businesses to determine the long-term economic and financial profitability of any investment project.

A capital budgeting decision is both a financial commitment and an investment. By taking on a project, the business is making a financial commitment, but it is also investing in its longer-term direction that will likely have an influence on future projects the company considers.

Motives for Holding Cash

Definition: The Motives for Holding Cash is simple, the cash inflows and outflows are not well synchronized, i.e. sometimes the cash inflows are more than the cash outflows while at other times the cash outflows could be more. Hence, the cash is held by the firms to meet the certain as well as uncertain situations.
Transaction Motive: The transaction motive refers to the cash required by a firm to meet the day to day needs of its business operations. In an ordinary course of business, the firm requires cash to make the payments in the form of salaries, wages, interests, dividends, goods purchased, etc.
Precautionary Motive: The precautionary motive refers to the tendency of a firm to hold cash, to meet the contingencies or unforeseen circumstances arising in the course of business.

Speculative Motive: The firms hold cash for the speculative purposes to avail the benefit of bargain purchases that may arise in the future. For example, if the firm feels the prices of raw material are likely to fall in the future, it will hold cash and wait till the prices actually fall.