8.7: Key Takeaways

Key Takeaways

Capital budgeting refers to the practice of evaluating long-term investments that firms undertake, such as building a new warehouse, opening a new production facility, developing a new product, or replacing existing equipment. Since the firm is really just a collection of all its past and future capital budgeting projects, this is one of the key components associated with maximizing shareholder wealth. Capital budgeting projects can be thought of as independent projects (where we want to accept all good projects) or mutually exclusive projects (where we can only take one from the set so must choose the best project). When evaluating capital budgeting projects, we need to make sure that we consider all the relevant cash flows the project is expected to generate, acknowledge time value of money, control for the riskiness of the expected cash flows and choose the project that adds the most to firm value. While there are many different techniques for evaluating capital budgeting projects, the three most common are Payback Period, Internal Rate of Return, and Net Present Value. Of these three methods, all are used in practice by a significant percentage of firms. However, only NPV (which is used most frequently) meets all four of the criteria we designate as critical in choosing projects. Therefore, when making decisions, NPV should be our primary decision tool.