

8.3: Capital Budgeting Decision Criteria

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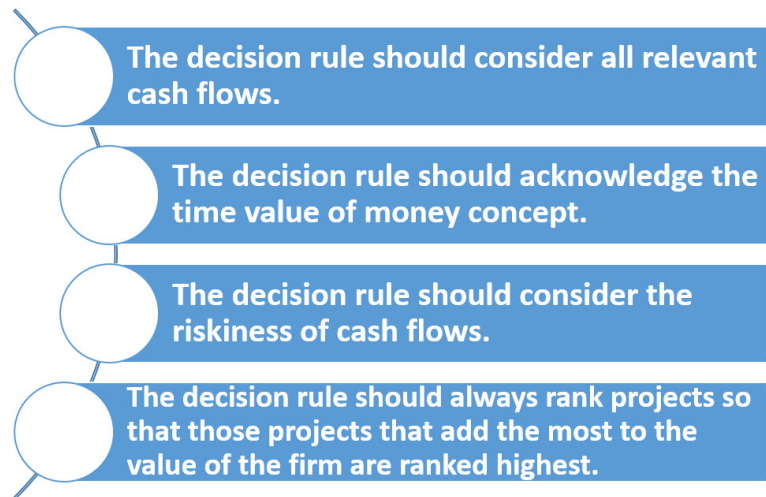


Figure 8.3.1: Decision tree for capital budgeting

Whatever capital budgeting decision rule we undertake should meet the following criteria:

The decision rule should consider all relevant cash flows

Some decision rules (such as the Payback Period) stop considering cash flows after a certain cutoff point. This may result in us making a poor decision, especially when trying to choose between two or more mutually exclusive projects. We also should note that it is important to be careful about evaluating relevant cash flows. For instance, consider your decision to attend college as a capital budgeting decision. It is easy to underestimate the cost if you do not acknowledge that you could be earning income during the time you spend in class and on homework. This is an opportunity cost and is just as important as actual dollars spent.

The decision rule should acknowledge the time value of money concept

Since capital budgeting projects are long-term investments, the cash flows which they generate are likely to take place years into the future. If a firm spends \$1000 today and receives back \$100 per year over the next 10 years, they have not broken even. Instead, the project has caused a significant reduction in firm value. This is because the present value of \$100 per year for 10 years is worth far less than the \$1000 spent today.

The decision rule should consider the riskiness of cash flows

As we have discussed since chapter one, investors are risk averse. Therefore, the riskier the projects that the firm invests in, the higher the rate of return they must earn to satisfy stockholders. If we don't adequately address risk in the capital budgeting process, we will find firms over investing in high risk projects and under investing in low risk projects.

The decision rule should always rank projects so that those projects that add the most to the value of the firm are ranked highest

This is something to be careful about. All decision rules will rank projects in some manner. However, if we are going to focus on maximizing shareholder wealth, then we want to rank projects based on how they add value to the firm. The more value the project generates, the more wealth is generated for our shareholders.

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