



Using your financial statements to evaluate capital budgeting decisions

Strategic investments — such as expanding a plant, purchasing a major piece of equipment or introducing a new product line — can add long-term value. But management shouldn't base these decisions on gut instinct. A comprehensive, formal analysis can help minimize the guesswork and maximize your return on investment.

Forecasting cash flows

Financial forecasts typically start with the most recent income statement. Then assumptions are made about 1) how much revenue (or cost savings) will the project generate, and 2) what incremental expenses will the project incur. In some cases, a project may create special tax savings (for example, first-year bonus depreciation or Section 179 deductions) that may need to be factored into the decision.

Strategic investments will also affect your company's balance sheet and statements of cash flows. For example, they may require additional working capital and fixed assets. Preparing comprehensive financial forecasts helps management evaluate how much cash the project will need each period and whether internal resources will be sufficient to finance it. Some projects will require the company to tap into the company's line of credit — or require additional loans or capital contributions.

Comparing investment alternatives

Company resources are limited. So, once cash flows have been forecasted, it's time to analyze the results and prioritize competing investment alternatives. For example, you might have \$50,000 to invest in either a new machine or IT upgrades. Which alternative is better from a financial perspective?

Three financial tools that are used to evaluate such decisions include:

1. Accounting payback period. This tells you how long it will take for a project to recoup its initial investment and start generating positive net cash flow — without considering the time value of money. For example, suppose a new machine that costs \$48,000 is expected to generate \$12,000 of incremental cash flow annually. Its accounting payback period would be four years (\$48,000 divided by \$12,000).

2. Net present value (NPV). This is a tool that discounts each period's forecasted cash flow into its present value. The sum of the present values for all the periods equals the project's NPV. If NPV is greater than zero, the project will generate positive cash flow and it's worth considering. If not, the project may not be worthwhile. Typically, management uses the company's cost of capital — or possibly a rate based on the risk of the investment — to discount forecasted cash flow.

3. Internal rate of return (IRR). This tool estimates a project's expected return on investment. This is the point at which a project's NPV equals zero. Management typically has a preset hurdle rate that a project must exceed to be considered. For example, if management sets its hurdle rate at 13%, any project with an IRR below 13% will be on the chopping block.

These financial tools may sometimes conflict with one another. So, it's important to consider qualitative factors, too. For example, IT upgrades might also protect against cyberattacks and reputational harm, which may be difficult to quantify in financial forecasts.

Need help?

Contact us to evaluate the quantitative and qualitative effects of strategic investment alternatives. We can help determine what's right for your situation.

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