Capital Allocation Within a Firm

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Abstract: This paper is concerned with decision making involving the allocation of resources for capital expenditures by a firm, which is a living system at the organization level. Our analysis is based on personal observations and will focus on the decision process used in large, multidivisional firms. This process begins with the firm determining the amount that is available for capital allocation. This amount is dependent on the firm's cash flow, which is the sum of depreciation, retained earnings, and deferred taxes. As managers submit proposals for new projects, the internal committee responsible for making the decision uses two criteria to select among the projects -- return on investment and the payback period. The paper considers the implications of this process for behavior of the managers within the organization. The credibility of a manager is a function of the accuracy of the estimated rates of return on past projects. The concept of "downside risk" and its relation to the process is introduced and discussed. Some of the standard economic literature on investment functions is criticized in light of our findings.