RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA III SEM.

SUBJECT: FINANCIAL MANAGEMENT

SUBJECT CODE: BBA 303

LECTURE: 12

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LECTURE-12

2.2 EVALUATIONS TECHNIQUES OF PROJECTS

The commonly used methods are following:

Traditional Method

Pay backs period method or pay out or pay off method
Rate of return Method or Accounting Method

Time adjusted Method or discounted method

Net present value method
Internal rate of return method
Profitability Index

2.2.1 Traditional Method

Pay Back Period Method:
It represents the period in which the total investments in permanent assts pay backs itself. This method is based on the principal that every capital expenditures pays itself back within a certain period out of the additional earnings generated from the capital assets thus it measures the period of time for the original cost of a project to be recovered from the additional earnings of the project itself.

In case of evaluation of a single project, it is adopted if it pays back itself within a period specified by the management and if the project does not pay back itself within the period specified by the management than it is rejected.

The payback period can be ascertained in the following manner: Calculate annual net earning (profit) before depreciation and after taxes; these are called the annual cash flows.

Where the annual cash inflows are equal, Divide the initial outlay (cost) of the project by annual cash flows, where the project generates constant annual cash inflows.

Where the annual cash inflows are unequal, the pat back period can be found by adding up the cash inflows until the total is equal to the initial cash outlay of project or original cost of the asset.

$$\text{Payback period} = \frac{\text{Cash outlay of the project or original cost of the asset}}{\text{Annual cash Inflows}}$$

Illustration 1. A project costs Rs1, 00,000 and yields annual cash inflow of Rs. 20,000 for 8 years. Calculate its pay back period.

Solution:

$$\text{Pay back period} = \frac{\text{Cash outlay of the project or original cost of the asset}}{\text{Annual cash Inflows}}$$

$$= \frac{1,00,000}{20,000} = 5 \text{ years}$$

Advantages of Pay Back Period

It is simple to understand and easy to calculate.
It saves in cost; it requires lesser time and labor as compared to other methods of capital budgeting.
This method is particularly suited to firm, which has shortage of cash or whose liquidity position is not particularly good.

Disadvantages of Pay Back Period

It does not take into account the cash inflows earned after the pay back period and hence the true profitability of the project cannot be correctly assessed.
It ignores the time value of money and does not consider the magnitude and timing of cash inflows. it treats all cash flows as equal though they occur in different time periods.
It does not take into consideration the cost of capital, which is very important; factor in making sound investment decision.
It treats each asset individually in isolation with other asset, which is not feasible in real practice.
It does not measure the true profitability of the project, as the period considered under this method is limited to a short period only and not the full life of the asset.