RAMA UNIVERSITY

www.ramauniversity.ac.in

FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA III SEM.

SUBJECT: FINANCIAL MANAGEMENT

SUBJECT CODE: BBA 303

LECTURE: 14

NAME OF FACULTY: DR. PALASH BAIRAGI

LECTURE-14

2.2.2 Time Adjusted or Discounted Cash Flows Methods

The traditional methods of capital budgeting suffer from serious limitations that give the equal weights to present and future flow of income. These do not take into accounts the time value of money. Following are the discounted cash flow methods:

Net Present Value Method: This method is the modern method of evaluating the investment proposals. This method takes into consideration the time value of money and attempts to calculate the return in investments by introducing the factor of time element. It recognizes the fact that a rupee earned today is more valuable earned tomorrow. The net present value of all inflows and outflows of cash occurring during the entire life of the project is determined separately for each year by discounting these flows by the firm's cost of capital.

Following are the necessary steps for adopting the net present value method of evaluating investment proposals.

Determine appropriate rate of interest that should be selected as the minimum required rate of return called discount rate.
Compute the present value of total investment outlay

Compute the present value of total investment proceeds.

Calculate the net present value of each project by subtracting the present value of cash inflows from the present value of cash outflows for each project.
If the net present value is positive or zero, the proposal must be accepted otherwise rejected.

Advantages of Net Present Value

1. It recognizes the time value of money and is suitable to be applied in situations with uniform cash outflows and cash flows at different period of time.

   It takes into account the earnings over the entire life of the projects and the true profitability of the investment proposal can be evaluated.
   It takes into consideration the on\objective of maximum profitability.

Disadvantages of Net Present Value

This method is more difficult to understand and operate.
It is not easy to determine an appropriate discount rate.
It may not give good results while comparing projects with unequal lives and investment of funds.

Internal Rate of Return Method (IRR):

It is a modern technique of capital budgeting that takes into account the time value of money. It is also known as “time adjusted rate of return discounted cash flows” “yield method” “trial and error yield method”

Under this method, the cash flows of the project are discounted at a suitable rate by hit and trial method, which equates the net present value so calculated to the amount of the investment. Under this method, since the discount rate is determined internally, this method is called as the internal rate of return method. It can be defined as the rate of discount at which the present value of cash inflows is equal to the present value of cash outflows. Steps required for calculating the internal rate of return.

Determine the future net cash flows during the entire economic life of the project. The cash inflows are estimated for future profits before depreciation and after taxes.

Determine the rate of discount at which the value of cash inflows is equal to the present value of cash outflows.

Accept the proposal if the internal rate of return is higher than or equal to the minimum required rate of return.

In case of alternative proposals select the proposals with the highest rate of return as long as the rates are higher than the cost of capital.