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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM.

SUBJECT: INTRODUCTION TO FINANCIAL MANAGEMENT

SUBJECT CODE: BCH 505

LECTURE: 15

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LECTURE-15

Determination of Internal Rate of Return:

    1. When the annual net cash flows are equal over the life of the assets.

        Present value Factor = <u> Initial Outlay </u>

    2. When the annual net cash flows care Unequal over the life of the assets.
Following are the steps

        Prepare the cash flow table using an arbitrary assumed discount rate to discount the net cash flows to the present value.
        Find out the net present value by deducting from the present value of total cash flows calculated in above the initial cost of the investment
        If the NPV is positive, apply higher rate of discount.
        If the higher discount rate still gives a positive NPV, increase the discount rate further the NPV becomes become negative.
        If the NPV is negative at this higher rate, the internal rate of return must be between these two rates.

Advantages of Internal Rate of Return Method

    It takes into account the time value of money and can be usefully applied in situations with even as well as uneven cash flows at different periods of time.
    It considers the profitability of the project for its entire economic life.
    It provides for uniform ranking of various proposals due to the % rate of return.

Disadvantages of Internal Rate of Return Method

    It is difficult to understand.

    This method is based upon the assumption that the earnings are reinvested at the internal rate of return for the remaining life of the project, which is not a justified assumption particularly when the rate of return earned by the firm is not close ton the internal rate of return.

    The result of NPV and IRR method may differ when the project under evaluation differ their size.

Profitability Index or PI: This is also known as benefit cost ratio. This is similar to NPV method. The major drawback of NPV method that not does not give satisfactory results while evaluating the projects requiring different initial investments. PI method provides solution to this. PI is calculated as:

PI   =   <u>Present value of cash Inflows</u>
                Present value of cash outflows

If PI > 1project will be accepted, if PI<1   then project is rejected and if PI= 1 then decision is based on non-financial consideration.

Advantages of PI method

It considers Time value of money

It considers all cash flow during life time of project.

More reliable than NPV method when evaluating the projects requiring different initial investments.

Disadvantages of PI method

This method is difficult to understand.

Calculations under this method arte complex