

Net present value model (npv)

Finance



Question The three main capital budgeting techniques are payback period, net present value (NPV) and internal rate of return (IRR). The payback period calculates the number of years that it takes a company to recover its original investment. An advantage of this method is that it is simple to calculate. A con of the payback period is that it does not take into consideration the time value of money. The net present value calculates the present value of future cash flows of a project. A project is accepted only if the present value is above zero. An advantage of this method is that it takes into consideration time value of money. A con of this method is that the numerical values can sometimes lead to erroneous decisions (Arya & Fellingham & Glover, 1998). The IRR is the rate of return a firm expects to earn if a project is accepted. Similarly to NPV an advantage of this method is that it takes into consideration time value of money. The biggest con of the method is that it is more difficult to calculate.

Question #2

A lot of companies prefer to use the internal rate of return method because this method quantifies the potential earnings of a project in the form of a numerical rate. The calculation of IRR is similar to finding the yield to maturity of a bond (Besley & Brigham, 2000). A project manager can know how much extra income a firm can obtain from a project.

Question #3

The capital budgeting evaluation technique that I prefer is net present value. This technique allows a manager to select the best project among several options. The project selected should be the one with the highest NPV value. Another reason that I prefer NPV over other capital budgeting techniques is because it is the best method to accomplish the goal of maximizing

shareholder's wealth (Besley, et al. 2000).

References

Arya, A., Fellingham, J., Glover, J. (1998). Capital Budgeting: Some Exceptions to the Net Present Value Rule. *Issues in Accounting*, 13(3). p. 499-508. Retrieved April 3, 2014 from <http://fisher.osu.edu/~young.53/AFG-NPV.pdf>

Besley, S., Brigham, E. (2000). *Essential of Managerial Finance* (12th ed.). Fort Worth: The Dryden Press.