Using expected values

Business

It is uncertain.

This is because it uses discounted cash flows rather than the real cash-flows of an investment. It is not appropriate when projects have limited funds. C (i) Profitability index is the ratio of the present value of future net cash flows to the initial cash outlay of the project. The index provides a relative measure for judging desirability and evaluating the worth of an investment proposal. The profitability index is thus a ratio of the present value of cash inflow at the required rate of return to the initial cash outlay of the investment. PI= PV of cash inflows/ initial cost outlay In a period of capital rationing accept a project if the profitability index is greater than 1, otherwise reject I f less than Where there are several projects whose PI is greater than 1, accept the project with greatest PI.

PI for investment X = PV of cash inflows/ initial cost outlay YEAR CASHFLOW PV FACTOR @ 14% PV 1 200 0. 877 175. 4 2 200 0. 769 153. 8 3 150 0. 675 101.

25 4 100 0. 592 59. 2 5 100 0. 519 51. 9 6 100 0. 455 45.

5 PV 557. 05 COST OUTLAY (200) NPV 357. 05 PI for investment Y = PV of cash inflows/ initial cost outlay YEAR CASHFLOW PV FACTOR @ 14% PV 1 80 0. 877 70. 16 2 80 0. 769 61.

523 40 0. 675 27 4 40 0. 592 23. 68 5 40 0. 519 20.

76 6 40 0. 455 18. 2 PV 296. 56 COST OUTLAY (100) NPV & 196. 26 Thus the PI for X = 357. 05/200= 1.

785 PI for Y= 196. 26/100 = 1. 9626 So you accept project Y because it has a higher PI. (iii) Limitations of profitability index Profitability index like other discounting methods uses the discounting factor that is uncertain. d) Capital purchases are subject to capital deductions'/allowances for tax purposes. This serves to reduce the tax burden on the investor.

Advantages of IRR. It considers the time value for money. It considers all cash flows It uniformly ranks all rates of return It focuses on maximum profitability of the shareholders funds Disadvantages of Internal Rate of Return it is a complicated method to understand It makes unrealistic assumptions It is not a realistic method of comparing mutually exclusive projects Advantages of AAR The accounting rate of return is simple to understand It is also used to appraise projects involving subsidiariesDisadvantages It doesn't consider time value of money It uses accounting data rather than cash flows hence limiting accuracy of capital projects. Linda Plc's investment appraisal method should factor in shareholders wealth. This is best done by use of NPV method.

Thus I recommend the company to adopt the NPV method is investment projects appraisal. Methods used in assessing the risk level of an investment project These methods include: Sensitivity analysis Its also referred to as the " what if analysis". It gives an analysis of the feasibility of a PROJECT BY ANALYSING INDIVIDUAL VARIBALE QUANTITIES. Break even analysis This allows an investor to determine the minimum production and sales quantity for each amount in an investment so as to avoid losses. f) Factors to consider when selecting a source of finance Cost. The cost of any source of finance is the driving force behind its selection Availability.

A source of finance is selected because it is available Flexibility This entails mode of payment, administration and obtaining the source of finance Taxation Some source of finance provides at taxable benefit to the company. This included debt capital financing unlike equity and Leasing