650 questions 3 and 4

Finance

Capital Budgeting Q1. Before making a decision on which investment to finance, finance managers are faced with thechallenge of choosing among the mutually exclusive investments. To make this determination, the best appraisal method should be selected. Most importantly, finance managers should only concentrate on appraisal approaches that take into consideration the time value of money.

In the analysis case, the use of the net present value method (NPV) should be preferred. The NPV of a project is the discounted value of all the future expected cash flows at the cost of finance. This method is the best since it considers the time value of money, incorporates all the future cash flows, and has clear criteria of how to decide whether to invest in the project. (Drake & Fabozzi, 2002) Besides, the rate used in discounting is the cost of capital which can be determined with certainty rather than being assumed. Drake & Fabozzi (2002) further underscores that in as much as the internal rate of return (IRR) is a good way of making an investment decision; it is a bit complex and sometimes results into conflicting results. IRR measures the expected rate of the investments that is made by an investor. In instances that the cash flows are both negative and positive, IRR has led to the determination of more than one rate of return thus making it difficult for an investor to make informed and profitable decisions. It should however be noted that in as much as the modified internal rate of return (MIRR) can be used where IRR is improper, MIRR is more complex and cannot be easily understood by those without financial knowledge. NPV thus remains a simple method of making investment appraisal that will certainly help maximize shareholders returns.

Q2.

To ensure that the limited resources are placed in the most profitable investments, the need for capital budgeting cannot be overemphasized. The use of the various investment appraisal methods have been exploited to help make capital budgeting decisions. Most importantly, NPV approach has been lauded as the best method of helping make capital decisions. Nonetheless, NPV alone is not sufficient since other important decisions affecting projects profitability cannot be easily determined by the use of this approach. Sensitivity analysis, scenario analysis, and Monte Carlo simulations have further been used to analyze the returns arising from investment portfolios. When using sensitivity analysis in making capital decisions, investors get to determine the extent to which a change in a specific cost variable influences project NPV. (Drake & Fabozzi, 2002) This assists in identifying which variables maximize investors' returns. On the other hand, scenario analysis is incorporated when analyzing the manner in which various changes in scenarios will affect Projects' NPV while Monte Carlo analysis is important when more than one variable change will influence capital budgeting decisions.

Capital budgeting should thus be carefully conducted in order to ensure that organizations derive optimum returns from investments. In executing these decisions, considerations of various cost and revenue elements that impact on the NPV are of projects are fundamental. Additionally, capital budgeting is also important when considering decisions on whether to dispose an asset, drop a particular line of business or make timing decisions. Thus it can be concluded that capital budgeting decision involves the use of the appraisal tools to help maximize shareholders' returns and should be professionally done.

Reference

Drake, P., & Fabozzi, F. J. (2002). Capital budgeting: Theory and Practice. NY: Wiley.