Applied managerial accounting essay examples

Finance, Investment

Business

Introduction

This essay is about research of comparing and contrasting the methods of evaluation in capital projects. This writing will include the information about the evaluation methods for NPV or Net resent Value, IPR or Internal Rate of Return, proposed projects ratio of payoff to investment or Profitability Index, and the Payback Method or the process of focusing to payback period which is the length of time that a project takes to recoup from the initial cost out. This paper will be written in a manner of providing separate evaluation for each method with the inclusion of study on the effect of a volume and price increase in sales as well as the discussion about a cost decrease on the net operating income over the last part of the essay.

Net Present Value (NPV)

Pamela Drake (n. d.) asserts that NPV are the current value of anticipated or expected cash flows. There fore, she says that if investing on a proposed project and the NPV is greater than $0, then it means that the investment will potentially increase shareholders' money. On the other hand, she says that having a NPV that is equal to $0 means that the investment may likely be unstable. However, the proposed project should be rejected if the NPV is less than $0 because it will potentially decrease the shareholders' money (Drake, n. d.). As to compare, Sarma (n. d.) says that the IRR is the rate of the discount that affects the NPV to be equals to zero, hence, considered to be the most useful of measuring the project worth (Sarma, n. d.). In contrast, the NPV shows that it is the cash flow amount that is expected to the project and the IRR is the one that makes the NPV equal, more than, or less than $0. Based on the project, the NPV @ 10. 8% is equal to 851, 532 which means that the IRR for this project doesn't have that much discounts that may reduce the NPV lower than 10. 8%.

Internal Rate of Return

The book Capital Budgeting Techniques (348) defines IRR as most used sophisticated capital budgeting technique (348). However, in consideration, this technique may be more difficult as to compare with NPV (348). This is the rate of the discount that makes the NPV equally with $0 or investment opportunity equals $0. IRR is the value of the yearly rate of income returns that the business will earn if it invests in a project and gets the cash inflows (348). In contrasts, The Internal Rate of Return or IRR is regularly used by organizations to evaluate and decide between investment projects. However, the Profitability Index will attempt to recognize the connection between the costs and benefits of a suggested project (Drake, n. d.). Based on the project, IRR is equal to 10. 8% which will be added to NPV of 851, 532. Drake (n. d.) also added that the decision rule on whether or not to accept the project is IRR should be greater than the capital amount; hence the investment may change to unstable if the IRR is equal to capital amount. However, the project should be rejected if the IRR is less than the capital amount (Drake, n. d.).

Profitability Index

Based on the Capital Budgeting Techniques (22), the Profitability Index is has a disadvantage in terms of problems with mutually priority or exclusive investments (22). However, advantages of Profitability Index can be considered in evaluating the capital projects because it maybe useful especially if the investment funds that are available are limited, this method is easier to communicate and understand, and it may help in making correct decisions when it comes to evaluating independent projects (22). The minimum acceptance criteria for PI should be more than 1.

Payback Method

Drake (n. d.) says that payback method focuses on the time period when the initial cash outflow that was invested has been added up with the cash inflows (Drake, n. d.) In other words, it is the method of evaluating the length of time of when is you going to earn back your invested money. Drake (n. d.) added that this method is also known as capital recovery period or pay off period. This method is also being used to decide on whether or not to accept the proposed project because this will provide the time and the expected amount that the shareholders will earn back after the given period. And as for the comparison and contrast, if pay back method is being calculated using the time period needed to recover the cost of a financial investment, the profitability index is measured by splitting the existing value of the project's upcoming cash flows by the preliminary investment.

Volume and Price Increase on Sales/Cost Decrease

Steven Symes (2013) says that price increase for an excellent or assistance offered by company will have an effect on the sales volume of that excellent service. How price increases affect consumer demand and consequently product revenue includes several key factors, making selecting a pricing strategy a complicated task that need to put thought and research into (Symes, 2013). It can b compare to the law of supply and demand wherein the price increase as the demand gets higher.

Joseph Schmitt (n. d.) explained that Operating income is often acquired the most appropriate evaluate of management\\'s ability to use an company\\'s operating resources. It provides a better evaluation of the company\\'s productivity pattern than net earnings. Supervisors can improve operating earnings by identifying each earnings statement component which feeds in to operating income, product sales income, price of goods sold or price of services and operating costs, which are selling and admin costs. A rise in operating income is a net effect. While leaders could improve product sales and reduce product costs, for example, operating earnings is the same if executive's paycheck increases in percentage (Schmitt, n. d.).

Conclusion

The payback period and the discounted payback period techniques provide us with a concept of the time it requires to restore and recover the amount invested in the project. Both of these techniques are frustrating because they do not actually consider all cashflows from a project. Further, there are no purpose criteria that we can use to assess a project, except for an easy requirements that project must have the payback.

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