Fundamentals of corporate finance - cost-benefit analysis, valuation principle, i...

Finance

Type the document [Type the document sub [Pick the dell Financial managers take decision on the basis of cost benefit analysis. However, accurate decision cannot be taken if current market prices are not incorporated in the analysis. Consider the following scenario, if ABC Company bought an asset three years ago for $10, 000 with an estimated life of four years. Current market price of the asset if disposed off is $4000, however, its book of accounts show $2500. If market price is not incorporated in the analysis, it would eventually lead to bogus decision. Therefore, it is essential for a financial manager to make current market price, an integral part of the analysis.

2. The Valuation Principle is a tool to assess the value today of cost and benefit associated with a decision. Moreover, this method will estimate value of an asset based on the cash flow stream in future. Cash flows are discounted to its present value through a concept of time value of money. The opportunity cost of the capital invested would be taken as discount rate. Opportunity cost is based on the relation of risk and reward associated with an investment therefore, incentive of higher return should be provided to accept the risk associated with it (Berk, Demarzo, & Harford, 2009). It could be of immense help for a financial manager while taking up a decision whether the company should undertake a new venture or not. If a business decides to make a venture whose net cash flow will result in an undesirable NPV then Valuation principle would help them choose a better alternative whose return is more than starting of a new venture.

3. Cost benefit analysis is an approach to assess whether the proposed project, policy or program is worth doing or not. It takes into account the

cost associated with the project with the benefit to be produced. It also involves comparison of alternatives and assesses which option should the company choose. Cost benefit analysis takes into account all relevant cost and a benefit associated with the project in future and discounts it back to present value. If the net present value (NPV) is undesirable, than the project would not be undertaken and other alternatives would be considered. In a nutshell, NPV provides the cost and benefit pertinent to an investment today so that future decisions could be taken on the basis of it. For example: If a bond with principal value of $1000 makes a balloon payment at the end of a year of $1150. Should a financial manager make an investment if he gets 10% return through a saving deposit? Yes, the investment should be made because NPV of the bond results in $45. The return is positive and it is a better investment than depositing money in a bank.

4. Interest rate is the price of money. It is the rate at which you can borrow or lend money. Moreover, it is determined by the demand of investment and supply of savings. As the interest rate is cost of borrowing, lowering it would encourage people to " buy" more and use it to investment or spend it somewhere else. Therefore, to avoid shortages or surplus, interest is set to equilibrium by the market forces. Consider the following example, if I want to borrow $1000 from the bank for a year and the current interest rate is 1%, than the marginal price I have to pay to borrow the given amount of money is $10.

5. Loan is a debt instrument in which, the borrower initially receives an amount of money, called the principal, from the lender, and is obligated to repay an equal amount of money plus interest to the lender at a later

time. The money is paid back in installments till maturity date. Likewise, bond has the same characteristics. The holder of the bond is the creditor (lender), the issuer of the bond is the debtor (borrower), and the coupon is the interest.

Works Cited

Berk, J., Demarzo, P., & Harford, J. (2009). Fundamentals of Corporate Finance. Pearson Prentice Hall.