

# [Cash flows for discounting calculations](https://assignbuster.com/cash-flows-for-discounting-calculations/)

Cash Flows for Discounting Calculations When managers are forecasting the cash flows for a project, they will consider the expected revenues and costs, but they must also include an estimate for working capital requirements. The working capital will be required in period 1 to allow the business to acquire inventories and build up debtors (receivables) to the extent that these are not matched by trade. The working capital will be recovered at the end of the project when the inventories are sold, cash is collected from customers, and final aments are made to suppliers.

The effect of taxation on cash flows Taxation has an effect on capital budgeting for two reasons. Tax payments are a cash outflow of the business, so it is important to know when they are payable. The government's tax policy may also try to encourage investment by reducing tax payable (also called tax incentives). Timing of tax payments if the company pays tax then the flows in respect of tax payments have to be included . The cash flows must then be discounted at the after-tax cost of capital.

UK companies that are not classed as 'small' for tax purposes pay their annual corporation tax in four installments spread across the year, so they have a cash outflow for tax every three months. For such companies the usual assumption in cash flow planning is that the tax outflow takes place in the year in which the profit is earned. The test of being 'small' is based on the amount of taxable profit. The small I-J companies pay their corporation tax in one amount, nine months after the end of the accounting year.

Discounted cash flows are usually calculated on an annual basis o these payment dates do not fit easily with an annual cash flow model. Examination questions usually make simplifying assumptions such as assuming the tax payment is made after 12 months rather than nine months. In the real world, an assumption has to be made about the timing of cash flows. In examination questions you will be given information about the assumption to be made. Tax incentives: capital allowances The government may try to encourage investment by making depreciation allowances (called capital allowances).

The capital allowance will be used to reduce the taxable profit and hence to reduce the tax bill payable. The effect of inflation Where inflation is expected during the forecast period, the question arises: do we have to adjust the forecast cash flows to take account of the expected rate of inflation? The cash flows and discount rate can be adjusted for inflation, and also shows that it is equally valid to forecast cash flows at constant prices discounted at the inflation-free rate of discount. Http://classical . Com/homework-help/accounting-homework-help/