

# Utilizing the time value of money

Finance



The profitability index is used as well in investment decisions because it measures the value created per dollar invested. So if the PI shows a greater than 1 value, then it means that the investment is returning a greater amount than invested. These two techniques are used because they resolve the disadvantages of NPV and IRR methods. (Helmkamp, 1990)

## 2. What are the disadvantages of NPV as an investment criterion

NPV is a very good starting point to know about the future profitability and success of an investment. However, this option is by no means perfect.

The first disadvantage of an NPV calculation is its dependency on the interest/discount rates. It is very difficult for the investor to know the correct discount rate since they can change throughout the life of that investment making considerable differences in the decision. (Investopedia, 2008)

Another issue with the discount rate is the differences in the risk factor of the investment. Since the risk can change, therefore the discount rate can make lives very hard in calculating NPV. (Investopedia, 2008)

Another disadvantage lies in the fact that NPVs are just mathematics calculations that do not take into account the real options available for investment. Since the investment, criterion needs to be defined beforehand and since the real investment options are not taken into the equation, a particularly good option in the future may be rejected. (Investopedia, 2008)

## 3. How will the change in the cost of capital impact the investment decision process

The cost of capital for a company is the cost of obtaining funds. This can happen either through the debts or the owner's equity. This means that if the cost of capital of one option changes; an investor would opt for the other option that has a lower cost and higher return. Therefore as long as the

investment offers a higher rate of return than the cost of capital, the investment will remain attractive because the return will exceed the cost of funds used to finance it. (Helmkamp, 1990)