PRINCIPLES OF FINANCE 2

LEARNING JOURNAL UNIT 3

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INTRODUCTION

When companies look at spending big money on new equipment or projects, they can't, like, just guess whether it's a smart idea. They need to run the numbers! In any business managers use to figure out if investments are sweet or Wack. Three popular ways are the payback period, net present value (NPV), and internal rate of return (IRR).

PAY-BACK PERIOD

This calculates how many years it will take to get back the cash you shell out upfront through the yearly profits that the investment starts raking in. You divide the starting stack of cash needed by those annual gains they think it'll make. Faster payback seems safer, so companies aim for that. "The term payback period refers to the amount of time it takes to recover the cost of an investment. Simply put, it is the length of time an investment reaches a breakeven point" (Kagan, 2023).

NET PRESENT VALUE

NPV deals with when money comes and goes. It takes the predicted profits and discounts them back to what they're worth today based on the company's cost of capital. Then that present value sum is stacked against the current cost. "In general, projects with a positive NPV are worth undertaking, while those with a negative NPV are not" (Fernando, 2024). Building in the time value of cash flows is clutch. But getting the real discount rate could mean searching a magic 8 ball for answers.

INTERNAL RATE OF RETURN

IRR gives back the expected return as a percentage rate. We're talking the exact discount rate making the NPV a big zero - the number where discounted profits just balance out the costs. If IRR is higher than what a company expects as their return goal, it's usually a go. However, IRR can get funky if cash flows get weird over time.

The internal rate of return (IRR) aims to determine the discount rate that equalizes the present value of anticipated annual cash inflows to the initial investment outlay. In evaluating new potential projects, companies can utilize several techniques to estimate expected returns, but IRR tends to be well-suited for assessing the possible yield of a new capital investment opportunity a company is evaluating taking on. By finding the discount rate at which net present value equals zero, IRR provides a means of comparing prospective project returns against a potential rate reflecting the minimum return threshold a company seeks (Fernando, 2024).

THE BOTTOM LINE - WHICH METHOD RULES?

In the investing business, NPV takes the trophy by making sure to factor for both money amounts and timing, NPV wants to maximize bank for the company's shareholders. Execs should roll with NPV plus the other rating methods to decide which project gets the green light. Payback period and IRR can assist, but they also have flaws that NPV stays away from. Internal rate of return (IRR) and net present value (NPV) serve complementary purposes in capital budgeting analyses. IRR's chief utility lies in its ease of comparison across investment options and in contexts lacking a clear discount rate. Meanwhile, NPV exhibits greater accuracy when cash flows follow irregular trajectories over the project lifespan or need discounting at

multiple rates. Thus, while IRR delivers a readily grasped performance metric for decision-making, NPV offers superior precision in valuing longer-term, complex investments. Using both techniques capitalizes on their respective strengths - IRR for its simplicity in project appraisal and benchmarking, NPV for its exactitude with intricate, multi-period cash flows requiring careful modeling (Palmer, 2021).

CONCLUSION

All three give helpful info on whether a major investment might blow up the company's budget or not. But when it comes down to it, NPV is better using discounted cash flow predictions. NPV seems to give companies the edge in good investing.

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