

DECISION MAKING AND SCENARIOS

MODULE 1.1 – Why Is Net Present Value Appropriate for Evaluating Projects?

Introduction

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Many Potential Criteria for Selecting Investment Projects

- Methods for selecting investment projects

What are the alternatives?

Return on Investment

Internal Rate of Return

Earnings per Share or Sales Growth

Payback

Market Share

Customer satisfaction

Net Present Value

Objective Function

- What are you trying to accomplish with the projects you select?

Maximize firm value

- Which criterion meets that objective?

The Net Present Value Rule

- Maximizing EPS or EPS growth does not necessarily meet that objective, nor do the others like increasing market share or customer satisfaction, payback, etc.

Key Ingredients for Evaluating Projects Using Net Present Values

- **Time Value of Money**
\$1 today is worth more than \$1 tomorrow
- **Incremental Analysis**
Forecast the change in after-tax cash flows of the organization because of the project
- **Cost of Capital**
Discount cash flows at the opportunity cost of capital





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