

9 Lecture - MGT201

Important Subjective

1. What is net present value (NPV) and how is it calculated?

Answer: Net present value is the difference between the present value of expected cash inflows and the present value of expected cash outflows. It is calculated by discounting all future cash flows to their present values and subtracting the initial investment.

2. What is internal rate of return (IRR) and how is it calculated?

Answer: Internal rate of return is the discount rate at which the present value of expected cash inflows equals the present value of expected cash outflows. It is calculated by trial and error or by using a financial calculator or spreadsheet function.

3. How is the required rate of return determined and why is it important in capital budgeting?

Answer: The required rate of return is the minimum rate of return an investor expects to earn on an investment. It is determined based on the investor's risk tolerance and opportunity cost of capital. It is important in capital budgeting because it is used as the discount rate to calculate the present value of future cash flows.

4. What are the advantages and disadvantages of using NPV as a capital budgeting technique?

Answer: The advantages of using NPV are that it considers the time value of money and provides an absolute dollar value for the project's profitability. The disadvantages are that it can be difficult to interpret for projects with multiple cash flows and it does not consider the risk associated with the project.

5. What are the advantages and disadvantages of using IRR as a capital budgeting technique?

Answer: The advantages of using IRR are that it is easy to understand and provides a percentage rate of return for the project. The disadvantages are that it can have multiple solutions and is more sensitive to changes in the discount rate.

6. How does the size and timing of cash flows affect NPV and IRR?

Answer: The size and timing of cash flows can affect the NPV and IRR calculations. A larger cash flow will have a greater impact on the NPV and IRR calculations than a smaller cash flow. Cash flows received earlier have a greater impact on NPV and IRR than cash flows received later.

7. What is the relationship between NPV and IRR?

Answer: NPV and IRR are both methods used to evaluate the profitability of investment projects. A project is considered acceptable if its NPV is positive or if its IRR is greater than the required rate of return. However, there can be situations where the two methods lead to different decisions.

8. How does the cost of capital affect NPV and IRR?

Answer: The cost of capital is used as the discount rate in the NPV and IRR calculations. A higher cost of capital will result in a lower NPV and a higher required rate of return for the project to be acceptable using the IRR method.

9. What are the limitations of using NPV and IRR in capital budgeting?

Answer: The limitations of using NPV and IRR include their sensitivity to changes in the discount rate, their assumptions about cash flows, and their inability to consider non-financial factors such as environmental impact or social responsibility.

10. How can sensitivity analysis be used to evaluate the risk associated with a capital investment project?

Answer: Sensitivity analysis involves examining how changes in assumptions, such as cash flows or discount rates, affect the NPV or IRR of a project. It can be used to evaluate the risk associated with a project by identifying which assumptions have the greatest impact on the project's profitability.