NPV vs IRR?

When analyzing a typical project, it is important to distinguish between the figures returned by NPV vs IRR, as conflicting results arise when comparing two different projects using the two indicators.

Typically, one project may provide a larger IRR while a rival project may show a higher NPV. The resulting difference may be due to a difference in cash flow between the two projects. Let's have a look first at what each of the two discounting rates stands for.

NPV

NPV stands for Net Present Value, and it represents the positive and negative future cash flows throughout a project's life cycle discounted today. NPV represents an intrinsic appraisal, and it's applicable in accounting and finance where it is used to determine investment security, assess new ventures, value a business, or find ways to effect a cost reduction.

IRR? IRR or Internal Rate of Return is a form of metric applicable in capital budgeting. It is used to estimate the profitability of a probable business venture. The metric works as a discounting rate that equates NPV of cash flows to zero.

Differences Between NPV vs IRR

Under the NPV approach, the present value can be calculated by discounting a project's future cash flow at predefined rates known as cut off rates. However, under the IRR approach, cash flow is discounted at suitable rates using a trial and error method that equates to a present value. The present value is calculated to an amount equal to the investment made. If IRR is the preferred method, the discount rate is often not predetermined as would be the case with NPV.

Corporate Finance

Corporate finance is the division of finance that deals with how corporations deal with funding sources, capital structuring, and investment decisions. Corporate finance is primarily concerned with maximizing shareholder value through long and short-term financial planning and the implementation of various strategies.

Corporate finance activities range from capital investment decisions to investment banking.

Understanding Corporate Finance

Corporate finance departments are charged with governing and overseeing their firms' financial activities and capital investment decisions. Such decisions include whether to pursue a proposed investment and whether to pay for the investment with equity, debt, or both.

Types of Corporate Finance Tasks

Capital Investments

Corporate finance tasks include making capital investments and deploying a company's long-term capital. The capital investment decision process is primarily concerned with capital budgeting. Through capital budgeting, a company identifies capital expenditures, estimates future cash flows from proposed capital projects, compares planned investments with potential proceeds, and decides which projects to include in its capital budget.

The time value of money (TVM) is a useful tool in helping you understand the worth of money in relation to time. It is a formula often used by investors to better understand the value of money as it compares to its value in the future. Below we'll go over the in's and out's of the TVM and how you can use it to understand the effect time has on the value of your money.

Time Value of Money The basic principle of the time value of money is that money is worth more in the present than it is in the future, because money you have now has the potential to earn. This is due largely in part to inflation. If you think about it, $1,000 in 1999 could buy you more than it could 20 years later, in 2019. And having a $1,000 today will theoretically buy you more than having $1,000 five years from now. With that in mind, the time value of money formula can help you determine the present value of the money you have today and how much it could be worth in the future.

With investing, however, there is a certain amount of risk you should consider as you use the time value of money. For example, saying you'll take that $1,000 and invest it in your favorite company that's expected to provide a 5% return each year is not guaranteed. Instead, with this any investment, you're accepting the risk of losing money for the chance to beat inflation and increase the future value of your money.