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How to Calculate Net Present Value (NPV) by Rodney Wincaster

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In general terms, Net Present Value (NVP) signifies the time value of money through periodic fluctuation. NVP calculations are performed to determine the outcome of various investment-related decisions. The basic concept of NVP revolves around the fact that a sum of money carries greater importance in present times as compared to future mainly because the investment returns of that amount would certainly be higher today than tomorrow.

Most capital budgeting decisions are based on the Net Present Value (NPV) calculations. You can easily predict the percentage of forthcoming cash flows to a certain extent by computing its Net Present Value (NPV) correctly. This calculation takes 3 main factors into consideration namely: The overall time-period of cash flow, rate of discount and net amount of cash flow.

Understanding the concept of Net Present Value (NPV)

If offered $ 200, would you choose to receive the amount at the moment or a year from now?

The obvious choice would certainly be to receive the amount at this moment for the simple reason that the net value of $200 would decrease in a yearâ€™s time, thereby fetching you reduced investment returns.

Net Present Value (NVP) calculations are therefore performed by comparing the total worth of a monetary sum received today to the amount received in future by subsequently incorporating the time period and rate of interest. This method helps in arriving at the projected value of financial investment made by a large-scale organization.

Let us take another example to comprehend the significance of Net Present Value (NVP) calculations while undertaking major financial decisions:

If a company is planning to launch a new product in the market, it is vital to be familiar with its overall initiation expenditure and the approximate percentage of cash flow that is expected over a period of time. On the basis of the projected incoming cash flow, one can easily use the NVP formula to determine the time limit within which the company would be able to recover the initial expenditure incurred on the product launch. The result of this NVP calculation would also help in analyzing if it is a viable option to launch this product in the first place and if this investment is worth taking the risk.

Simplest way to Calculate the Net Present Value (NPV)

â€¢ Determine the preliminary investment amount for an upcoming project, also referred to as the project cost. For example, letâ€™s assume the outlay of funds for this project as $100

â€¢ Establish the minimum discount rate for this assignment over a period of 24 months. Letâ€™s assume the discount rate to be approximately 3%

â€¢ Ascertain a specific value (Value1, Value2 etc.) to the cash payment that is most likely to be made at the end of two years. Letâ€™s say your project guarantees a definite return of $200 after 2 years

â€¢ Now compute its Net Present Value (NPV) by using the formula

NPV = C*t/ (1 + r)? â€“ C, whereby

(C*t stands for return after period, C. stands for project cost, t stands for the time period and r stands for the discount rate)

NPV = $200/ (1+.03)Â² - $100

Therefore the solution comes to

NPV = $200/ (1.03)Â² - $100 = $200/1.0609 - $100 = $188.52 - $100 = $88.52

With a Net present value of $88.52, this investment is worth the risk as it promises returns that is almost as much as the original investment.

You can also use an online NPV calculator in order to determine if the investment on a forthcoming project would grant favorable returns in the future.

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