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CAPITAL BUDGETING: DISCOUNTED CASH FLOW ANALYSIS

Introduction

Capital budgeting is one of the vital methods of finance utilized in managing and appraising a firm’s long-term investments. Of these, one can single out Disounted Cash Flow (DCF) analysis which has been acknowledged as one of the most effective techniques. This method makes it possible to estimate the value of an investment which depends on the cash or other foreseeable income it is likely to generate in the future and which in most cases is discounted to present value.

Discounted Cash Flow Analysis

Discounted Cash Flow calculation involves coming up with the expected amount that an investment will make and then reducing this amount by the required rate of return. The basic concept that is used here is timeliness value whereby money today is valued more than the same amount of money in the future given its ability to earn. Therefore, DCF analysis is more advantageous in the determination of the actual value of investment due to its consideration of the time value of money.

Determine the Discount Rate

This is risk related to the investment and incorporates the fact that an investment with a lower risk will be provided at a higher discount rate. It is normally calculated using the company cost of capital or the required rate of return or using data from prior periods.

Conclusion

DCF analysis is a very sound technique for capital budgeting because it is in a position to provide firms with the real value of investments. Due to adjusting for the time value of money, DCF gives a complete view of the investment's profitability and its risk profile, which makes it an essential part of any strategic financial model.

Recommendations

1.

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2.

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