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20 One-Liners | Capital Budgeting NPV and IRR: The Complete CAIIB ABFM Guide for Decem

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20 One-Liners to Remember

Quick-fire facts for last-minute revision.

- 1 NPV stands for Net Present Value, the difference between present value of inflows and outflows.**
It measures the value a project adds in today's rupees after discounting future cash flows.

- 2 The NPV decision rule is to accept a project if NPV is greater than zero.**
A positive NPV means the project creates value for the bank.

- 3 IRR stands for Internal Rate of Return, the discount rate at which NPV equals zero.**
IRR represents the project's true annual percentage return.

- 4 The IRR decision rule is to accept a project if IRR exceeds the cost of capital.**
An IRR above the financing cost means the project earns more than it costs to fund.

- 5 When NPV and IRR conflict on mutually exclusive projects, the NPV method should be followed.**
NPV measures absolute value added in rupees, which is theoretically superior for ranking mutually exclusive projects.

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- 6 NPV measures absolute value added in today's rupees, while IRR measures a percentage return rate.**

This distinction explains why a smaller project can show a higher IRR but lower NPV than a larger project.

- 7 IRR can produce multiple answers when a project has multiple cash-flow sign changes, making it unreliable in such cases.**

NPV avoids this problem and gives one consistent answer regardless of sign changes.

- 8 NPV assumes reinvestment of cash flows at the cost of capital, which is considered a more realistic assumption than IRR's.**

IRR assumes reinvestment at the IRR itself, which can be unrealistic for high-IRR projects.

- 9 For projects with equal annual cash flows, IRR can be estimated using the annuity-factor shortcut and interpolation.**

Dividing the initial outlay by the annual inflow gives a PV annuity factor to look up in annuity tables.

- 10 Salvage value should be added to the operating cash flow of the final year before discounting, not discounted separately.**

Treating salvage value as a separate, mis-timed flow is described as a frequent costly error.

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- 11** **Five components appear in every capital budgeting problem: initial investment, cash inflows, salvage value, discount rate, and the accept-or-reject decision.**

Identifying these components first makes the subsequent calculation mechanical.

- 12** **The initial investment outlay at Year 0 is treated as a negative cash outflow in capital budgeting calculations.**

Future cash inflows are then discounted back and compared against this outflow.

- 13** **Capital budgeting is described as a heavily tested quantitative topic in the CAIIB ABFM paper.**

ABFM stands for Advanced Business and Financial Management, a compulsory CAIIB paper.

- 14** **If a question provides pre-tax cash flows and a tax rate, they should be converted to after-tax cash flows before discounting.**

Using pre-tax flows directly when a tax rate is given would overstate the project's value.

- 15** **A bank's cost of capital used in NPV and IRR problems is described as depending on its funding mix and asset-liability management strategy.**

This links capital budgeting decisions to the broader ALM framework covered in banking.

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16 Riskier projects generally justify use of a higher discount rate in NPV calculations.

A higher discount rate compensates for the additional credit or counterparty risk of the project.

17 Every future cash flow in an NPV problem must be discounted back to Year 0 using the time value of money.

Undiscounted cash-flow totals are treated as an incorrect approach in capital budgeting problems.

18 In a worked branch-opening case with a 200 lakh setup cost at 13% cost of capital, the computed NPV came out negative.

A negative NPV in that example meant the branch proposal destroyed value on pure financial grounds.

19 IRR cannot generally be solved with simple algebra for irregular cash flows and instead requires trial and error or interpolation.

Financial calculators or annuity-table interpolation are used to approximate IRR in such cases.

20 Confusing IRR with the cost of capital is listed as a common mistake in capital budgeting problems.

IRR is what the project earns, while the cost of capital is the minimum return the bank requires.

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