

NET PRESENT VALUE OF MONEY



vEcoSys

**Understanding what is
“net present value of money”
– By Prof. *Simply Simple*™**



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Two friends Shekhu and Pheku were sitting under a tree and engrossed in some discussion

They had a problem on hand



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Sheku's father had agreed to pay him Rs 1 cr. to help him settle in life But Pheku's father had made another arrangement. Not sure of Pheku's maturity, he promised Rs 1.2 cr after 3 years



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Pheku was showing off his offer to Sheku saying that his father has given a much better deal. However Sheku not ready to give up argued that his deal was better because he was getting paid immediately.

Now this argument went on for several hours till it was evening. However this problem was just not getting resolved



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This argument was taking place just in front of my office. Seeing these guys' argument stretch across the entire day, I got curious and walked up to them to understand their problem.

When they explained their positions, I offered to intervene provided they stop their argument.



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I told them that in order to compare their situations it would be necessary to find out the net present value of the Rs 1.2 cr that Pheku had been promised after 3 years.



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Here it is important to understand that the purchasing power of money reduces almost every day due to the rise in price of goods and services due to inflation.



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Therefore the value of Rs 1.2 crores after 3 years needs to be discounted by an assumed rate of inflation. Let's say the rate of inflation we assume is 8% per annum



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The formula for calculating the net present value or

$$NPV = \text{Amount}/(1+R)^n$$

- where Amount is the Rs 1.2 cr that Pheku would get after 3 years.
- “R” is the rate of assumed inflation and
- “n” stands for 3 year period



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So using the formula we get

$$\begin{aligned}\text{NPV} &= 1.2/(1+.08)^3 \\ &= 1.2/(1.08)^3 \\ &= \text{Rs 95 lacs}\end{aligned}$$



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Thus I told Pheku that the net present value of the money promised to him is Rs 95 lacs and hence it less than what Sheku is receiving.



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I thus told them that one should simply not get blindly excited by an amount being offered in the future. Inflation is our constant companion and hence it is imperative to calculate the present value of all future cash flows for comparison



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Hope this lesson has succeeded
in clarifying the concept of
“net present value”



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