Net Present Value Schema

1. Decide on the measure—in the sense of a “standard unit used to express the size, amount, or degree of something”—for example, 2010 dollars or 2011 operating income).
2. Make a convention for inflows and outflows of the unit of measure.
3. Specify when flows of the measure that differ across the alternatives occur.
4. Compute the net flow of the measure in each period for each alternative.
5. Discount the net flows in each period to the present.
6. Adopt the alternative with the highest NPV.

Remember that:

- An implicit alternative may be to do nothing. “Do nothing” projects may have an implicit NPV of zero.
- The appropriate discount rate is the nominal after-tax, inflation- and risk-adjusted cost of capital.
- Working capital generally is returned at the end of the project.
- GAAP depreciation never results in a cash flow, but tax depreciation does reduce either current taxes payable or, if the entity is presently in a loss position, can result in a recovery of past tax payments or a reduction in future tax payments.
- When projects are a mutually exclusive and exhaustive set of alternatives, the project with the highest NPV is best, even if all projects have negative NPVs.