

# Finance Equations Answers

## FINANCE EQUATIONS & ANSWER

### A STUDY GUIDE

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#### TIME VALUE OF MONEY

**AMORTIZATION EQUATIONS**  
A loan, such as a mortgage or car payment, in which the loan is paid off in equal periodic installments.

**FORMULA:**  $A = P \frac{r(1+r)^n}{(1+r)^n - 1}$

Where:  
A = payment amount per period, P = initial Principal loan amount  
r = interest rate per period, n = total number of payments or periods

**ANNUAL PERCENTAGE RATE (APR)**  
Annual Percentage Rate (APR) is the interest rate that reflects all the costs of that loan during a one year time period.

**FORMULA (single payment):**  $\text{APR} = \frac{\text{Average Annual/Planned Charge} + \text{Annual Equivalent of Periodic Interest}}{\text{Annual Equivalent of Periodic Interest}}$

**FORMULA (installments):**  $\text{APR} = \frac{2AP}{P(N+1)}$

Where:  
n = number of payment periods in one year, N = number of scheduled payments (i.e. Number of payments or dates, P = original loan)

**EFFECTIVE ANNUAL RATE**  
is used to determine the actual annual rate that would be paid on a loan or investment if the stated annual rate is affected by compounding.

**FORMULA:**  $EAR = \left(1 + \frac{r}{m}\right)^m - 1$

Where:  
r = Nominal interest rate, m = Compounding frequency per year.

**EFFECTIVE INTEREST RATE**  
Real rate of interest for a loan.

**FORMULA:**  $\text{Effective Interest rate} = \frac{\text{Nominal Interest Rate}}{\text{Real Interest Rate}}$

**FUTURE VALUE (FV)**  
The future value of money is how much it will be worth at some time in the future. The future value formula shows how much an investment will be worth after compounding for set time periods.

**FORMULA:**  $FV = PV(1+r)^n$

Where:  
F = the future value of the investment, P = the present value of a note and n = time.

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#### CAPITAL BUDGETING & DISCOUNTED CASH FLOW APPLICATIONS

**CERTAINTY-EQUIVALENT APPROACH**  
The certainty equivalent approach is a guaranteed return that someone would accept, rather than taking a chance on a higher, but uncertain, return.

**FORMULA:** After Tax Cash before a Certainty equivalent Coefficient

**NET PRESENT VALUE (NPV)**  
NPV is used in capital budgeting to analyze the profitability of an investment or project. NPV analysis is an indicator of the desirability of future cash inflows that an investment or project will yield.

**FORMULA:**  $NPV = \sum_{t=1}^n \frac{CF_t}{(1+r)^t} - C_0$

Where:  
n = Time, t = cash flow period  
r = interest rate assumption  
C<sub>0</sub> = initial investment

**INTERNAL RATE OF RETURN (IRR)**  
The discount rate often used in capital budgeting that makes the net present value of all cash flows from a particular project equal to zero. Generally speaking, the higher a project's internal rate of return, the more desirable it is to undertake the project.

**FORMULA:**  $0 = \sum_{t=1}^n \frac{CF_t}{(1+IRR)^t} - C_0$

Where:  
n = number of cash flow  
CF<sub>t</sub> = cash flow at period t  
IRR = Internal Rate of Return

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## FINANCE EQUATIONS ANSWERS



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