The Importance of the Time Value of Money and its Applications in Stocks and Bonds Valuations

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Abstract

When making a financial decision, it is extremely vital to recognize the time value of money (TVM). Decisions such as procurement of loans and purchase of assets affect the firm's future cash flows. The value of money depreciates with time and hence the value of money today is higher than a year henceforth (Muda and Hasibuan, 2018). For instance, the purchase of an asset will necessitate immediate cash outlay and is expected to generate cash flows for the foreseeable future. Similarly, procuring a loan from a commercial bank has future obligations on repaying the principal amount and the interest. Also, the issuance of shares means that the cash balance would increase, but cash outflow will be experienced on the payment of dividends to the shareholders. Therefore, a sound decision-making process should seek to make the cash flows logically comparable (Johari et al., 2018). The concept of present value and future value helps the decision-makers to make viable solutions aimed at maximizing wealth.

Making cash flows logically comparable requires adjusting the cash flow differences in risk and timing. Consideration of the risk and time value of money is crucial in the process of deciding both the individual investors and corporations (Alikar et al., 2017). However, when risk and value for money are ignored in the course of making an investment decision, firms fail to achieve the desired goal of maximizing shareholders' wealth. Thus, investors use the net present value of money to establish the viability of investments (Weber, 2020). Also, the concept of present value helps in ranking the possible investment options, and the investors can choose the project that promises the highest yield.

The driving factors for establishing the time value of money include; inflation, risk and uncertainty, investment opportunities, and consumption (Petters and Dong, 2016). The future is full of risks and uncertainties. For instance, future cash inflow is uncertain. Thus, in the process of decision making, risk, and the present value of money are considered. In most cases, firms prefer receiving cash immediately since it can be invested and earn interest in contrast to receiving the same payment at a later date. Inflation is a common aspect of any market. The present value of money has more purchasing power than future cash inflow (Marty, 2017). More so, inflation reduces the purchasing power due to the high prices of commodities in the market. Current consumption is another factor that drives individuals and firms to consider the present value of money. Current consumption is preferred for future consumption (Almansoori and Nobanee, 2019).

For example, Saudi Arabia is an Islamic state, and interest rates are termed as haram according to their religious belief. Thus, a concept of the TVM does not have a significant impact on a process of decision-making. For instance, the TVM is not applicable in Islamic legal practice thus it does not apply to lending (Hung, 2016). A borrower can obtain a loan from the creditor at no interest. The process of decision making while doing business in Saudi Arabia is different due to the difference in the definition of money. Money is defined as the medium of exchange but not the value store (Baur and Lagoarde-Segot, 2016). Thus, money cannot perform any function on itself rather than being exchanged for assets or services and do not earn interest.

The concept of TVM from an Islamic perspective takes into account a positive time preference. Thus, time is regarded as the valuable resource of economy (Yang et al., 2016). For instance, prices can be varied in cash and credit terms since time is a valuable economic resource. Thus, the credit price is higher than the cash price (Jindal and Solanki, 2016). Thus, managers in Saudi Arabia should consider minimizing credit purchases to avoid high costs associated with credit purchases. However, on the supply side, credit sales are referred to as they translate to higher returns. In this case, the idea of the TVM is pegged to the current consumption and the associated opportunity cost. Thus, the use of funds should be compensated since there is a foregoing of current consumption.

Another important aspect while doing business in Saudi Arabia and any other Islamic state is the fact that there is no increase in any principal amount entered into a contract (Muda and Hasibuan, 2018). Thus, an increase from Islamic financing is only determined upon maturity and not on an upfront basis as in the case with interest-bearing financing contracts. Also, an increase in the principal amount is voluntary, and the debtor has an obligation to set the increment terms and the amount to be repaid (Al Mheiri et al. 2021).

The process of decision-making involves a lot from a global perspective. The Islamic perspective on the time value for money differs entirely from the conventional time value for money. Whereas the general perspective on the value of money over a period changes, the Islamic perspective on the TVM is mainly based on the agreement between the debtor and the creditor, and interest for the money borrowed is paid voluntarily, or none is paid at all.

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