

# [Capital budgeting](https://assignbuster.com/capital-budgeting-essay-samples-2/)

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Capital budgeting Capital budgeting EEC calculation for NPV, IRR, and Pay Back for the investment opportunity YEAR CASHFLOW   
RATE OF DISCOUNTING= 14%=(1+r)-n   
NPV   
0   
($2, 000, 000)   
1   
($2, 000, 000)   
1   
$500, 000   
0. 8772   
438600   
2   
$500, 000   
0. 7695   
384750   
3   
$500, 000   
0. 675   
337500   
4   
$500, 000   
0. 5921   
296050   
5   
$500, 000   
0. 5194   
259700   
6   
$500, 000   
0. 4556   
227800   
7   
$500, 000   
0. 3996   
199800   
8   
$500, 000   
0. 3506   
175300   
9   
$500, 000   
0. 3075   
153750   
10   
$500, 000   
0. 2697   
134850   
NPV=$607730   
IRR CALCULATION   
Internal Rate of Return= NPV÷Initial investment   
IRR=$607730÷$2000, 000   
IRR= 0. 30   
IRR= 30% Percent   
Calculating   
payback for the investment opportunity   
PAY BACK= INTIAL INVESTIMENT÷ CAHFLOW PER PERIOD   
PAY BACK=$2000000÷$500, 000   
PAY BACK= 4 Years   
Pay Back= 4 Years   
Based on the calculations above EEC should acquire the supplier because the net present value is positive. This means that EEC will generate wealth from the project. In addition, the positive NPV obtained from the calculations above indicate that if EEC carry out the project it will be profitable (Arthur, 2014).   
Of the three techniques namely; NPV, IRR, and payback period, the most useful tool to use in project valuation is the NPV. Unlike IRR and Payback techniques, the NPV is a very accurate tool that helps to determine if the project will be profitable to the organization or not. In addition, NPV approach provides a clear indication on how the profits will be obtained, unlike IRR and payback approaches. Therefore, the NPV is the most useful tool in project valuation (Arthur, 2014).   
Of the three techniques (NPV, IRR, and payback period, the least useful tool to use is the IRR, because discount rate has an inverse relationship with NPV. When NPV continues to increase, the anticipated future cash flows become less valuable and hence making IRR least useful tool to use in project valuation. On the other hand, payback approach is the second least useful tool to use after IRR. The Payback period indicate how long the cash flow obtained from the project will recover the initial capital outlay. In addition, the payback period fails to indicate the amount of cash flow to be generated from the project. However, it is the simplest method of calculating project forecast (Arthur, 2014).   
The answer would not be the same because a negative NPV will be obtained when cost of capital increases from 14% to 25%. It means that as the cost of the capital increase the return obtained from the project decreases significantly up to a negative (Peterson & Fabozzi, 2002). Such decrease makes the project un-profitable and, therefore, it is advisable for the EEC not to invest when cost of capital increases to 25%.   
If EEC did not save an even cash flow of $500, 000 per year, the answer would be the same. The least amount of investment that would make this investment attractive to EEC is $100, 000. From the above scenario, the EEC would be willing to pay the supplier $2000, 000.   
MEMO   
To: EEC President   
From:   
Date:   
Subject: CAPITAL BUDGETING   
(a) EECs cost of capital increases   
The president of EEC should be aware that if the cost of capital increases as discussed above, the underlying effect is a negative NPV. It means that the project will be no longer profitable to the company (Arthur, 2014).   
(b) The expected savings are less than $500, 000 per year   
If the expected savings are less than $500, 000 per annum, it will be difficult for the ECC to pay its supplier a capital of $2000, 000, and hence, the project will not yield any benefit to the EEC (Arthur, 2014).   
(c) EEC must pay more than $2 million for the supplier   
If EEC must pay more than $2000, 000 the project will generate a negative NPV. Such project should not be undertaken, as it will lead to loss to the company (Arthur, 2014).   
References   
Arthur., P. (2014). An Introduction to Capital Budgeting. Retrieved: Peterson, P. P., & Fabozzi, F. J. (2002). Capital Budgeting: Theory and Practice. Hoboken: John Wiley & Sons.