

Good analyzing payback period method essay example

[Business](#), [Company](#)



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Answer 1)

Payback Period is one of the most simple technique of capital budgeting where it is used to ascertain the time it will take for the entity to recover its initial cash outflows from the cash inflows generated by investment project. It is an important determinant as no business organization would like to invest in projects with long payback time period.

Payback period is calculated with following formula:

Payback Period= Initial Investment/ Annual Cash Inflows

Answer 2)

Secondly, it is the simple and easy applicability of the payback period which is the another reason for continued applicability of the payback period method.

Answer 3)

In order to evaluate the usefulness of Payback Period, author commenced his work on a model where he used Payback Period with a constant growth but without discounting cash flows. The model was a replica of assumption of Gordon Growth model used in stock valuation where growth is assumed to be constant in the firm. Similarly, under this model also, the author assumed constant growth rates of the cash flow to the firm, where they proved that payback period can be used to summarize the projected future cash flows by capturing two primary factors of cash flow i. e ratio of initial outlay(I) to the next period projected cash flow and the projected cash flow growth rate(g). In summary, they proved with the help of model that payback period is positively associated with the ratio I and negatively related to G and this relationship between Payback Period, G and I allows investors to consider the cash flows beyond the payback period if a payback is explicitly determined based on the cash flows up the payback period.

Answer 4)

Considering the drawback of payback period method that it does not consider the time value of money, is duly considered by the authors which they duly solves using the discounted cash flow method of Payback Period. The discounted payback period uses the present value of the project's estimated cash flows. It is the number of years it takes for a project to recover its initial investment in present value terms and therefore must be greater than the payback period without discounting. In other words,

discounted payback period addresses one of the drawbacks of the payback period by discounting cash flows at the project's required rate of return.

Formula for Discounted Payback Period:

Discounted Payback Period: Full years until recovery + [unrecovered cost(cumulative) at the beginning of the last year/ Cumulative Cash flow during the last year]

Answer 5)

Yes, Payback Period indeed have practical relevance as most of the managers are using this method primarily because of simplicity associated with it. Also the importance of risk and uncertainty that the payback method has included has really been of such a great advantage and in favor of payback period. Moreover, the relationship established by the authors between Payback Period, Growth Rate and Initial Cash Out flow both under discounted and non-discounted cash flows will be a great benchmark for the future researchers to work on extended practical relevance of payback period in the corporate decision making.

Works Cited

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