

# Analysis of the project if continued with only new product with optimistic sales ...

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The capital budgeting decision is a very critical an important decision. Capital investments require a lot of cash out flows which are done in order to get higher benefits in future. As the capital is invested with the view of getting higher returns in future, therefore the capital should the decisions regarding the investments should be taken with utmost care by analyzing the capital investments by capital budgeting techniques. A lot of capital budgeting techniques are used to analyze the capital investments among them the most popular ones are net present value and internal rate of return. The net present value can be described as the excess of present value of cash inflow over the present value of cash out flow (Brigham and Ehrhardt, 2010, p. 383). In this project the investment decision has been taken by both net present value method and the internal rate of return method. The incremental cash flows have been prepared with the help of the projected sales and costs figures. While computing the incremental cash flows the expenses regarding the research and other expenses done before the implementation of the project as these expenses are sunk costs and does not depend upon the implementation of the project. The main calculations have been done on the base or most likely projections. The tax shield which is required to calculate the cash flows have been computed as per the tax provisions as the main objective of the

analysis is to determine the exact cash flow position due to the implementation of the project. More over with the variable cost, fixed cost and initial capital expenditure the organization would also have to invest during the project tenure on working capital therefore this has also been included in the analysis. The cash out flows will include the working capital requirements which will be recovered at the end of the project. At the end of the project the organization will receive the balance of the working capital on that day. No matter with which ever method the investment decisions are evaluated the importance of the cash flows remains same for each and every method of capital budgeting. While commuting the cash flow it is very important to consider the product cannibalization costs that are the revenue forgone for initiating the new project (Shapiro, 2008, p. 63). These are deducted from the revenues from the new project. This is done to ensure that the sales from the new products should cover up the loss from the foregone sales of the existing product. Project acceptance or rejection The decision criteria of net present value method is that the projects with positive Net present value that is if the discounted cash inflow is greater than the discounted cash out flow then the project should be accepted. While analyzing the most likely data of the projected sales and costs it has been found that the present value of cash inflow is more than the cash out flow hence the project should be accepted. Again on computing the internal rate of return it has been found that the IRR is more than the cost of capital, the cost of capital is 15% where as the internal rate of return of the project is almost 20% therefore the project should be accepted. Through this analysis it can be said that if the project is initiated then the company will be able to

recover all its costs incurred and also the rate of return will also be much less than the internal rate of return. Table 1: NPV and IRR as per base scenario Analysis of the project if continued with only new product with optimistic sales figures As there has been a debate on the sales figure that is the projected sales figures and the exclusion of the manufacturing contract from the analysis therefore a study has been made on the optimistic sales value of the project and the exclusion of the manufacturing contract from the analysis. The study has been made on if the sales can be made 10% more than the most likely data. Table 2: NPV and IRR of the project with 10% increase in sales From the analysis it is clear that if the sales figures are forecasted 10% more than the base year then the internal rate of return will be more than the required rate of return which signifies that the project should be accepted as the criteria of IRR acceptance is that the IRR should be greater than cost of capital. As the NPV is also positive therefore in this scenario also the project should be accepted. Analysis of the project if project with only new product It has been found that if the project is implemented without contract manufacturing then the company will not be able to recover all its incremental costs and the internal rate of return will also be lower than the required rate of return. In this scenario the company should not implement its project. As the net present value is negative therefore the company should not go ahead with the project without contract manufacturing work. Table 3: NPV and IRR of the project without considering manufacturing contract Analysis of the project if project implemented with contract manufacturing and pessimist sales of new product If the project is implemented with contract manufacturing and sales of the new product

decreases by 5% then the company will be able to recover its costs and also be able to earn more return than the costs of capital. Therefore if the company realises sales of the new product less than 5% of the projected figure then also it will make profit. Hence in this case it should accept the project. Table 4: NPV and IRR with 5% decrease in sales of new product

Recommendations The project have been analysed from every scenario that is with the most likely data optimistic sale pessimistic situation and continuation of the project with and without contract manufacturing. After analysing all these scenarios it is recommended that the project should n be accepted as the company with contract manufacturing work. If the company go ahead with the project with new product only then there will be a chance that the company will not be able to recover all its costs related to the project including the foregone revenue from the current product. Hence it is recommended that the company should accept the project and utilise the remaining capacity of the new equipment by contract manufacturing.

Reference Bringham, E. F. and Ehrhardt, M. C. (2010). Financial Management Theory and Practice 13th ed. USA: Cengage Learning. Shapiro, A. C. (2005). Capital Budgeting and Investment Analysis. India: Pearson Education India.