FIN722 GDB SPRING 2013 SOLVED

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# Topic: Capital Budgeting Techniques & Analysis

## Discussion Question:

In discounted payback period (DPBP), present values of cumulative cash inflows are considered instead of simple cumulative cash inflows in order to analyze the time period a project would take to pay the initial investment back. So, DPBP is the combination of traditional (simple) payback period (PBP) & present value (PV) approaches.

Stars Incorporation is a leather manufacturing concern and it is going to evaluate an independent project, having useful life of 10 years, by using the DPBP and NPV criteria. Conventional cash flows are attached with the project. Company's target (maximum acceptable) discounted payback period is 4 years while project's calculated discounted payback period turns to be greater than this target DPBP but less than the useful life of the project.

If company rejects this project, whether it will create any concern for the company and why? Provide logical reasoning in favor of your answer.

If company prefers the NPV criterion over the DPBP criterion then what can be the rationale behind this decision?

**Important Notes:**

- Answer should be to the point and logical.
- Definitions and unnecessary details (just to make the comments lengthy) are not required.

**Solution:**

**Part 1**

A project is profitable if the discounted payback period is (DPBP) is less than numbers of years of operation of a project.

Although the DPBP is more than the management target DPBP but less than the operation of a project , so it will increase the wealth of a company, so company may consider to accept the project.

**Part 2**

The principal goal of company is to maximize the shareholders wealth. The NPV will tell us how much the project will increase the owner's wealth. NPV is coinciding with the objective of financial management. If NPV is positive it means it will increase the wealth of owner. In given situation NPV is positive as its discounted payback period is less than the operation of a project.

The DPBP will not tell us how much will increase in wealth of investor while NPV tell us the increase in wealth. The DPBP criteria are subjective in nature and may set according to company future prospects and overall business conditions. The project will accept if NPV is positive.