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Advance Corporate finance

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"Advance Corporate finance Assignment"

⇒ Question:-

Summarize the 6 chapter in your own word in hand written format.

⇒ Six chapter summary:-

There are number of argument justify the use of NPV, and may have already seen the detailed one.

The NPV is positive, the project should be accepted of course, a bank interest rate above 7 percent would cause the project NPV to be negative, implying that the project should be rejected. Thus the basic

point is "Accepting positive NPV project benefits the stockholders"

NPV of the project by discounting all the cash flow

If the project were risky then could determine the expected return on a stock whose risk comparable to that project.

⇒ Rule Definitions:

One of the most alternative to NPV is the payback period rule. Here is how the payback period rule works. Consider a project with initial investment of \$50,000. Cash flows are \$30,000, \$20,000 and \$10,000 in first three year. These flows are illustrated.
(- \$50,000, \$30,000, \$20,000, \$10,000)

The minus sign in front of the \$50,000 remind us that there is cash outflow for the investor, and the commas between the different number indicate that they are received. The firm receive cash flow of \$30,000 and \$20,000 in the first two year which add up to the \$50,000 original investment.

This means that the firm has recover its investment within two year.

⇒ Problem with Payback Method:

There are at least three problem with the payback method. To illustrate the problem of the two, we consider the three project in table. All three have the same

three pay year payback period, so they should all be equally attractive.

⇒ **Problem 1:-** Timing of cash within the payback period. Let us compare project A with project B. In year 1 through 3, the cash flow of project A rise from \$20 to \$50 while cash flow B fall from \$50 to \$20. This show that the payback method is inferior to NPV because we pointed out earlier the NPV approach discount the cash flows properly.

⇒ **Problem 2:-**

* **Payment after the Payback Period:-** Consider project B and C which have identical cash flow of \$60,000 in the fourth year.

⇒ **Problem 3:-**

• **Arbitrary standard for Payback Period:-** Consider a third problem with the payback approach. When a firm uses the NPV approach it can go to the capital market to get the discount rate.

⇒ **Payback Period rule:-**

The payback period is not same as the NPV and is therefore

Therefore conceptual wrong with its arbitrary cut off date and its blindness to cash flow system that date it can lead to some flagrantly foolish decision if it is used too literally. This means that we should be wary of trying change rule like the payback period rule.

⇒ The discounted Payback rule:-

Aware of the pitfalls of the payback approach some decision makers use a variant called the discounted pay rule. Under this approach, we first discount the cash flows. Then we ask how long it takes for the discount cash flow to equal the initial investment.

⇒ The average Accounting return:-

Another attractive and fatally approach to making financial decision is the average accounting return. The average accounting return is the average project earning after taxes and depreciation divided by the average book

best value of the investment during its life. In spite of its flaws, the average accounting return method is worth examining because it is used frequently in the real world.

⇒ The internal rate of return:-

Now we come to the most important alternative to the NPV approach - the internal rate of return, universally known as IRR. The IRR is about as close as we can get to NPV without actually being the NPV. The basic rationale behind the IRR is that it tries to find a single number that summarizes the merits of a project. The number does not depend on the interest rate that prevail in the capital market.

⇒ Problem with IRR approach:-

A independent project is one whose acceptance or rejection is independent of the acceptance or rejection of other project. For example imagine McDonald is considering a hamburger outlet on a remote island. Acceptance or

rejection of this unit is likely to be unrelated to the outlet in question insofar that it will not pull sale away from other outlet.

⇒ Profitability Index:-

The method this is used to evaluate project is called the profitability index. It is the ratio of the present value of the future expected cash flow after initial investment divided by the amount of the initial investment. The profitability index can be represented as.

$$\text{Profitability index (P)} = \frac{\text{PV of cash subsequent to initial investment}}{\text{Initial investment}}$$