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Chapter 10 Risk and Refinements in Capital Budgeting

10-3 LG 2: Break-even Cash Inflows and Risk

a. **Project X**
 $PV_0 = PMT \times (PVIFA_{10\%,12})$
 $PV_0 = \$10,000 \times (13.332)$
 $PV_0 = \$133,520$

 $NPV = PV_0 - \text{Initial investment}$
 $NPV = \$133,520 - \$30,000$
 $NPV = \$103,520$
Calculator solution: \$103,521.55

Project Y
 $PV_0 = PMT \times (PVIFA_{10\%,12})$
 $PV_0 = \$15,000 \times (13.332)$
 $PV_0 = \$200,000$

 $NPV = PV_0 - \text{Initial investment}$
 $NPV = \$200,000 - \$40,000$
 $NPV = \$160,000$
Calculator solution: \$160,282.33

b. **Project X**
 $SCF_x = 3,352 = \$30,000$
 $SCF = \$30,000 + 3,352$
 $SCF = \$33,352$

Project Y
 $SCF_y = 3,352 = \$40,000$
 $SCF = \$40,000 + 3,352$
 $SCF = \$43,352$

c. **Project X**
Probability = 60%

Project Y
Probability = 25%

d. Project Y is more risky and has a higher potential NPV. Project X has less risk and less return while Project Y has more risk and more return, thus the risk-return trade-off.

e. Choose Project X to minimize losses; to achieve higher NPV, choose Project Y.

10-4 LG 2: Risk Sensitivity Analysis

a. Range A = \$1,800 - \$200 = \$1,600 Range B = \$1,100 - \$900 = \$200

b.

Outcome	Project A		Project B	
	Table Value	Calculator Solution	Table Value	Calculator Solution
Pessimistic	-5,6297	-5,629729	-5,337	-5,33779
Most likely	514	513.56	514	513.56
Optimistic	7,325	7,32441	1,365	1,36492
Range	\$13,622	\$13,621.70	\$1,702	\$1,702.71

c. Since the initial investment of projects A and B are equal, the range of cash flows and the range of NPVs are consistent.

d. Project selection would depend upon the risk disposition of the management. (A is more risky than B but also has the possibility of a greater return.)