

## **FNCE 20005 Corporate Financial Decision Making 2021**

### **TUTORIAL 6: Advanced topics in capital budgeting: Sensitivity, break even and decision-tree analyses**

#### **SECTION A**

##### **Question 1**

Outline possible problems that you might have in implementing sensitivity analysis in practice.

##### **Answer 1**

*The problems encountered in using sensitivity analysis are as follows:*

- (a) frequently, it is difficult to specify precisely the relationship between a particular variable and net present value – and in fact identifying all variables that impact upon a project's NPV might be near impossible;*
- (b) estimates of variables are not independent over time in that an unexpected change in a variable in one period may have implications for the reliability of estimates of other variables in that period and that variable in later periods; and*
- (c) it can be difficult to specify the distribution of values that a variable might take – which is exactly what is required for an analyst to arrive at their “optimistic” and “pessimistic” values.*