

I. Synthesis

Courtney Jones, an MBA graduate of a southern university, was recently hired by Pete Parker, the owner and CEO of Franklin Lumber. Although Parker admits that he has had negative encounters with MBAs, he views Jones differently because of her sensitivity to real-world complexities as well as her impressive communication and people skills. Parker has given Jones her first task: (1) to conduct a financial analysis on two new machines that Parker is considering, and (2) "critique" the company's capital budgeting policies.

The plywood division is an integral part of the company's operations, with nearly two entire plants dedicated to the production of plywood panels. The plywood division is operating nearly at peak, and Parker is seriously considering the acquisition of an additional plywood press in order to expand. They have two options for models: Nakoi (made in Japan) and Dakota (made in America). Each cost \$750,000 and \$1,300,000, respectively, including installation. Dakota is nearly double the price of Nakoi, but it has three advantages. First, it has a higher daily output rate; second, it is easier to operate, resulting in lower labor costs; and finally, it can retain its value better because it is a more modern system.

Parker's capital budgeting practices are known as fixed asset purchasing guidelines (FAPG). The plan should suit the company's mission and the project should not be outside the lumber industry. For relatively small investments, the company relies solely on the payback method, at least two-year payback and three-year tops. For more expensive proposals, Parker uses somewhat different techniques. The payback is still used, in part because Parker uses it as a first measure, and in part because it is easy to calculate. He wishes to assess the project's return by estimating the investment's average accounting rate of return (AARR), which can be calculated by dividing the project's average annual net income by its average book value. He also acknowledges that he dislikes seeing a project's payback period exceed five years.

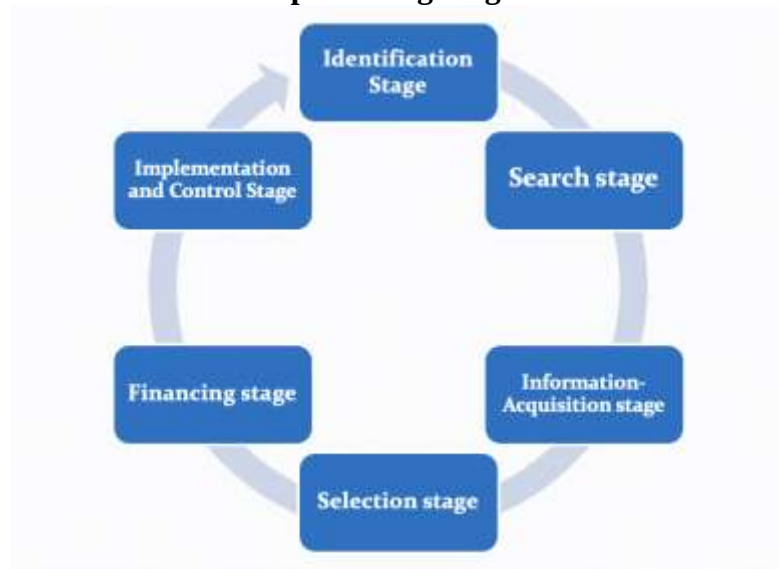
In Parker's opinion, the most critical aspect of capital budgeting decisions is the precision of forecasts, and he goes to great lengths to make this clear to the firm's executive. He constantly reminds them that forecasters must be truthful seekers of truth if the business is to be the best it can be. Later on, Jones reflected on her conversation with Parker. According to Jones, the main disadvantage is the lack of any discounted cash flow strategy. The target return of 20% is a book value, not a market value. Parker also seems to be able to consider capital budgeting based on market returns. Jones understands the importance of explicitly justifying and explaining her recommendation.

II. Point of View

This case study takes from the perspective of Courtney Jones, Financial Analyst at Franklin Lumber, as assumed.

D. Theoretical Framework

The Capital Budgeting Process



Based on Horngren, Datar & Foster (2015), Pearson

Capital budgeting is a process followed by decision-makers to identify which long-run projects and programs to accept or decline. This involves providing a quantitative view, particularly looking into the costs and benefits of each project that serve as a basis for making management decisions. For this case study, the capital budgeting process will serve as our theoretical framework in achieving our objectives to the case. There are six stages in capital budgeting:

1. Identification Stage – During the first stage of the process, investment opportunities are explored. Usually, there are multiple alternatives for each initiative.
2. Search Stage – The management will start to look into each alternative capital investment and determine if these are necessary to achieve the objectives and strategies of the company.
3. Information-Acquisition Stage – The third stage entails estimating the costs and benefits, including the risks involved in each capital investment. Decision-makers should be able to provide quantitative support for the initiative to make financial sense.
4. Selection Stage – The management will start choosing the programs or projects and line them up for approval.
5. Financing Stage – At this stage, the company will start to identify financing sources to implement the project.
6. Implementation and Control Stage – The project is executed in line with an implementation plan with deadlines and key milestones. During this stage, the management should be able monitor and track the progress in terms of costs, cash flows involved and benefits derived from the project.

b. Average accounting rate of return (AARR)

Dakota's Financial Data

Average Accounting Rate of Return (AARR)

Cost of Life @ Year 0: 1,300,000

Lifespan	Accumulated Depreciation	Book Value	Net Income
Year 1	185,714	1,114,286	213,891
Year 2	371,429	928,571	213,891
Year 3	557,143	742,857	213,891
Year 4	742,857	557,143	213,891
Year 5	928,571	371,429	213,891
Year 6	1,114,286	185,714	213,891
Year 7	1,300,000	0	213,891

Average Book Value: 650,000

Average Net Income: 213,891.43

AAR 32.91%

c. IRR

Dakota's Financial Data

Internal Rate of Return (IRR)

Cost of Life @ Year 0: 1,300,000

Lifespan	Cash Flow
Year 1	399,606
Year 2	399,606
Year 3	399,606
Year 4	399,606
Year 5	399,606
Year 6	399,606
Year 7 (With salvage value)	789,606

IRR 26.27%

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