Capital budgeting slp

Health & Medicine

Capital Budgeting Introduction Investment decisions are trade-offs between project risks and returns. Assessing investments on the basis of past performance to inform decisions may lead to project failure and bankruptcy. Various changes impact on the future performance of firms including growth in assets and equity. The current paper underpins concepts in capital budgeting based on the Trinity Hospital case study. The paper discusses the financial condition of the Hospital and the likelihood that it has sufficient cash flow over the next five years to pursue the project. In addition, recommendations for pursuing the project in the described case study are presented.

The financial health of the hospital can be evaluated by examining its liquidity, profitability and leverage. The three measures are internal financial management issues. In particular, liquidity refers to the ability of the company to meet its cash obligations or pay its expenses, and is related to the availability of assets to cover liabilities (Flex Monitoring Team, 2005). Profitability refers to the ability of the hospital to generate financial returns sufficient to replace assets and compensate investors (Flex Monitoring Team, 2005). The measures for profitability focus on calculating financial returns on investments. On the other hand, leverage is the percentage of capital from investors as compared with creditors.

Current assets:

$1, 500, 000 m in revenue in 2010 and 1. 3 m in 2011

Equity is $2, 000, 000

Delayed third party payments in 2011 $500, 000

Expected grants of $250, 000 in 2011

Current liabilities:

Operating costs of $1 m in 2010 and $1. 2M in 2011

Debt of $150 in 2010 and 2011

Employee pension scheme $150, 000 in 2010 and 2011

Malpractices costs were $150, 000 in 2010 and 2011

Depreciation of $100, 000 in 2010 and $105, 000 in 2011

No tax.

Current assets = $1, 300, 000 + $2, 000, 000 + $500, 000 + $250, 000 = $4, 050, 000

Current liabilities = $1, 200, 000 + $150, 000 + $150, 000 + $150, 000 + $105, 000 = $1, 755, 000

Net working capital = current capital – current liabilities

= 4, 050, 000 - 1, 755, 000= $2, 295, 000

Current ratio= 4, 050, 000/1, 755, 000 = 2. 3

Current liabilities refer to the monies owed by the hospital that will fall due within one year of operation while current assets refers to the sum of cash, receivable accounts, inventories or other items that the hospital can convert into cash in the short-term (Gill and Chatton, 2001). Current ratio ascertains the company’s liquidity or the working capital position. It is a robust measure and gives insights on whether the company used its short-term assets to pay its current liabilities. The calculated current ratio is 2. 3 indicating the capital the business uses to run its operations. Furthermore, the hospital has equity of $2, 000, 000. Equity is the amount that remains if all liabilities were paid off and all assets sold at book value (Vance, 2003). The hospital is therefore in good financial health.

Investment activities

Expected cash flows from investment: $100, 000, $150, 000, $200, 000,

$225, 000 and $300, 000 Revenue projections are estimated at $50, 000 increases from 6th year to 10th year.

Payback period

N

CF

CF x PVIF

DCF

CUMULATIVE DCF

0

-1000000

-1000000 x 1

-1000000

-1000000

1

100000

100000 x 0. 86957

86956. 52

-913043. 48

2

150000

150000 x 0. 75614

113421. 55

-799621. 93

3

200000

200000 x 0. 65752

131503. 25

-668118. 68

4

225000

225000 x 0. 57175

128644. 48

-539474. 2

5

300000

300000 x 0. 49718

149153. 02

-390321. 18

(NPV)

The calculation indicates that there is no pay back period.

Net Present Value

The Net Present Value for the investment is -390200

Internal Rate of Return

The Internal Rate of Return is -0. 722%

Recommendations

Based on the calculations, the project should be rejected. The NPV is used to analyze cash inflows for the project taking into consideration the investment returns and inflation. The investment would present a negative NPV (-390200) and IRR (-0. 722) indicating that the project is risky in the given time horizon. The hospital should therefore evaluate its risk tolerance by considering the time horizon and or bankrolling the investment.

References

Flex Monitoring Team (2005). Financial indicators for critical access hospitals. Briefing Paper No. 7, retrieved January 23, 2012 from www. flexmonitoring. org/documents/BriefingPaper7_FinancialIndicators. pdf

Gill, J. & Chatton, M. (2001). Financial Analysis: The next step. New York: Axzo Press.

Vance, D. (2003). Financial Analysis and Decision Making: Tools and Techniques to Solve Financial Problems and Make Effective Business Decisions. New York: McGraw-Hill Professional.