Guillermo furniture capital budget techniques

Finance

Guillermo Furniture is a midgrade, high-end sofa manufacturing company owned by Guillermo Navallez. Due to an increase in competition Guillermo Furniture has suffered a loss in its yearly sales. Owner Guillermo Navallez is considering changes within the company to make it more competitive and to increase company sales. He is evaluating two different methods of change; one would involve the purchase of expensive hi-tech equipment and the other would change the primary function of the business to distribution with manufacturing be done on high end products alone.

Guillermo would like to review capital budgeting techniques to help project which road he should take to revitalize his business if any. Capital budgeting is a process used by most companies use to approve investments on major long-term projects that require a significant amount of capital to be used. Because large sums of capital typically have limited availability, capital projects are evaluated on an individual basis, most using both outflows and inflows of cash. Net Present Value The net present value (NPV) measures the discounted value of cash inflows to cash outflows, to determine the profitability of a capital investment.

The investment is deemed profitable if the net present value is greater than zero. The NPV is calculated by subtracting cash outflows (cost of investments) from the present value of future inflows (freedictionary). Internal Rate of Return The internal rate of return (IRR) is the rate that the present value of cash inflows equal cash outflows. IRR is an estimation of the total return of the project over the life of the project assuming all cash flows are reinvested at the projects return rate. This method will provide Guillermo with an idea of what the project might earn over the life of the project.

Once the IRR is determined it can be compared to the desired rate of return Guillermo wishes to receive to determine whether or not to accept or reject the project. The IRR is not a simplistic calculation and should be done using software such as Excel (Edmonds, et. al. 2007). Payback Period The Payback period technique simply calculates the amount of time it will take to earn your initial investment back from the project. Typically the shorter the payback period the more attractive the project is to business owners.

The payback period is equal to the net cost of the investment divided by the annual net cash inflows. The payback period does not make any assumptions of profit or return on investment (Edmonds, et. al. 2007). Recommended Technique All three techniques would provide Guillermo with valuable data to select the best possible investment project for the company. How long it will take to earn back the initial investment, whether or not the project will be profitable and the return on the investment (ROI) are all important factors to be considered by any business owner when considering a large capital investment.

Using a hurdle rate of 12% for a 5 year term the present value needed for purchasing hi-tech equipment would be ($1, 731, 453. 32) compared to ($2, 236, 255. 78) for becoming a Broker of units. Reviewing all three methods on the Capital Budget Spreadsheet, indicates that the Brokering project would be the better of the two investment options for Guillermo. The payback period for brokering is less than a year compared to 8. 3 years for purchasing hi-tech equipment. As well the IRR for brokering is 124% compared to 3% for the hi-tech project.