

Pressco case study

Business



We have experienced some small reductions in the late uses, however the introduction of Supply-Side economics into mainstream policy indicates more favorable rates as rumored are on the horizon, making this a better time to spend money and reduce our taxable income. The projected cost savings will not begin until we are likely to be benefiting from a more favorable tax rate, letting us make more money when it costs us less in terms of taxation.

We are spending when spending is cheaper and making more money when making money is cheaper as well. I have provided additional detail on the options and my rationale below.

Assessment of Investment Cash Flows: Assuming purchase of the equipment for cash, at a total cost of \$2.9 million, there are several possible scenarios to consider: tax and depreciation rates remaining as they are or changing and the loss or continuation of the Investment Tax Credit (TIC). Without providing an excess of detail here, those scenarios include: a possible tax rate decrease from the current level of 46% to 34%, possible extension of depreciation to 7 years, and the possible repeal for the TIC tax credit, as well as the usability of "Grandfathering" the last two options.

Additional detail on these calculations and the possible permutations considered is available in Appendix A. To summarize my findings, purchase options resulted in net present values ranging from \$1.4 million to \$1.9 million for a return on our investment over the next 10 years. Assessing the likelihood of each option and assigning weight to each possibility is an inexact science, but I believe it is unlikely that in the current political climate

we will not see both a reduction in the tax rate and an increase in the length of time over which we are required to depreciate capital assets.

I have assigned weights to each option with this in mind, and have come up with an average weighted estimate of the net present value of the investment of: \$1.7 million. Alternatives to Purchase: As opposed to purchasing new equipment, we could opt to maintain the equipment we currently have, which has an estimated service life of 11 years remaining. We could retain all of our claimed Investment Tax Credit for this purchase, which has two years of depreciation left, and would not be required to invest in any new training for our employees.

We would recognize \$31,000 in depreciation in present value terms, as well as save an estimated \$200,000 in training costs and losses due to lower production during the "learning curve". I estimate these savings to be approximately one month of payroll to include both the time spent on training, and our reduced in-house production as employees learn how to use the new equipment.

Totaling all alternatives, this option is provided in Appendix B, C, & D. In conjunction with keeping the existing equipment, we would have the opportunity to make a different investment with the \$2.9 million. Current Taxation Environment:

The current Congress and Presidential administration have made a number of changes to the business environment through taxation and associated regulations in the past several years. As such, it is important to consider as many likely and reasonable options as possible when evaluating the effects

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of taxes on capital purchases. With the election of President Reagan, the previously more fringe notion of Supply-Side Economics has begun to be implemented, starting first with the Economic Recovery Tax Act of 1981, which in addition to other business incentives, accelerated depreciation for capital expenditures to 5 years.

This provision was repealed the following year as part of the Tax Equity and Fiscal Responsibility Act of 1982. We saw the back & forth over reducing tax rates and providing spending incentives to businesses again with the failed Tax Reform Act of 1983 which ultimately was rolled into the Tax Reform Act of 1984. It has become clear that the one thing we do know about the future situation of business tax is uncertain. Because of the strong bias of the current Presidential administration towards lowering tax rates, I believe that it is likely we will experience a certain degree of life in that area.

However, it is more important than ever at this time that we not depend to heavily on benefits derived from more favorable tax treatment. As such, it is in our interest to also determine if a given project will produce a positive financial result, even in less favorable taxation scenarios.

Fuel Efficiency Considerations: Of the \$560, 000/year savings Presses, Inc. Has estimated we will enjoy as a result of purchasing their equipment, \$360, 000 (or 64%) is allocated to fuel-efficiency. Therefore, we must closely examine the current climate surrounding fuel efficiency.

There are two components to considering the effect of fuel economy: the possibility of future tax incentives and/or penalties for fuel efficiency in manufacturing, and the price of fuel. The most likely scenario for tax

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incentives to increase fuel efficiency will be in the form of credits for purchases, which through buying now we will likely not be able to take advantage of.

Penalties for higher fuel consumption may be levied at a point in the not-too-distant future as the Federal Government strives to both more comprehensively address environmental concerns, and regulate the price of fuel.

We saw both of these in The Energy Policy and Conservation Act of 1975, and with the Highway Revenue Act of 1982, which temporarily increased the gasoline excise tax by \$0.05 (an increase from \$0.04 to \$0.09). The Energy Policy and Conservation Act of 1975 established reserves of crude oil and gave the President the authority to order maximum domestic production as well as rationing and conservation measures in times of crisis.

This is important because these measures are clear indicators of the interest the Federal Government is taking in reducing and stabilizing fuel prices.

When looking at the history of fuel prices, I see that we are in a period of unusually high prices. It is of critical importance that we evaluate the likelihood of prices remaining this high for the life of the equipment in order to consider how much of SUE, U/year savings is credible in ten long-term. From BIBB tongue ten the price of crude oil was fairly consistent with the price of inflation, but in 1973 as a result of the oil embargo, crude oil prices increased four-fold. Prices remained fairly stable at this level through the rest of the decade, increasing three-and-a-half-fold again with the war in Iran again disrupting production.

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Most recently, OPEC has been unsuccessful in setting production quotas low enough to stabilize prices, and they have again begun to drop. While we cannot expect prices to drop back to their 1971 levels, it is wise to examine the effect of lowered fuel prices on the overall investment value. Reducing the savings attributed to fuel efficiency by 25% (\$270, 000/year) reduces the weighted average net present value of the investment to \$1. 5 million, and reducing those savings brings the net present value to \$1. 2 million. Still arguably viable, but less attractive.

See Appendix E & F for additional detail.

Conclusion: While the savings proposed by Presses, Inc. May not be as great as anticipated by their marketing representative, we are still in a strong position to make this purchase with cash available and take advantage of the cost savings. Even if the savings attributed to fuel efficiency are h of what is projected, the equipment will still provide an investment value of over \$1 million in excess of the purchase price. Additionally, even if our tax rate were to stay the same, we would continue to realize financial benefits, making this investment one that is based o more than mere speculation or salesmanship.