Capital planning

Finance

Capital Planning Answer Capital Planning for a business organization is a budgetary exercise while making capital expenditures in plant and machinery or establishing any production facilities to produce a good as the activity entails considerable capital investments. Capital Planning is also known as investment appraisal or capital budgeting in the financial world. Internal rate of return is important to the business organization because it ascertains whether the project under consideration provides higher or lower rates of return than the one that can safely be obtained in the financial market. That is why it is also known as " economic rate of return (ERR)". When multiple projects are presented to the organization, the project that gives the highest internal rate of return will be selected for investment.

It is important to know about the net present value of the project because then the investor can decide whether it is worth investing in a project or not. When multiple projects are presented to the organization, all available future streams of returns, until its full useful life, will be converted to its present value and the project that gives highest net present value will be the most lucrative of the projects that are available for investment. Thus, net present value (NPV) is an appraisal technique to arrive at the conclusion to invest in a most lucrative project, from a financial perspective.

Answer 2.

Leasing is a novel way of financing machinery, equipment, computer or any other asset without paying the full amount upfront. The lessor (financer) and the lessee (receiver of the asset) are the two parties involved in any leasing agreement in which the lessee needs to pay agreed lease charges, monthly or yearly, for the use of the asset. The advantage is that the person need not worry about arranging funds to buy the asset. It is better to lease an asset in which obsolescence rate is quite high. When one is interested in using the asset rather than owning it, it is better to lease the asset (Murray, 2012).

The following steps are employed while deciding about whether to buy a computer system or lease them.

a) Finding outright purchase cost of buying a computer system (assuming $500 in our case).

b) Finding leasing rates of computer system and duration ($220 each for 3 years. First installment is paid at delivery and subsequent two installments after the completion of first and second year).

c) Finding present value of all leasing rates applying appropriate discount rates (6%, as per the current market).

d) Comparing outright payment versus present value of all leasing rates to be paid over its useful life. If the present value of the leasing cost is not substantially higher than outright purchase (around 20%), I would go for leasing the equipment.

In this case, the present value of all three leasing payments can be calculated as per the following.

= 220 + 220/1. 06 +220/ (1. 061. 06)

= 220 + 207. 55 +195. 8

= $603

This means that I am paying $103 or (103/500) 100 or 20. 6 % higher cost while going for leasing. Since it falls within the range, I will go for leasing the computer system.

References

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