

General foods, case analysis essay



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General Foods Corporation is a major manufacturer of consumer food products. The corporation is organized into two separate divisions for its product lines in the United States and their foreign operations. Some of their major U. S. product lines include Post, Kool-Aid, Maxwell House, Jell-O, and Birds Eye. General Foods is considering introducing a new product line called Super, an instant desert.

After conducting research General Foods found that powdered deserts represented a large and growing section of the total desert market and after test marketing their new product they feel that Super can capture ten percent of the total dessert market. The problem management faced is how to appropriately measure and allocate costs associated with the project as well as whether to accept or reject the project based on costs and future cash flows generated by Super. With regard to The Super Project or any capital budgeting decision, financial instruments and standards such as payback periods, NPV, and IRR are important.

Funds or costs allocated to projects have an opportunity cost because other uses for this money exist. What is more, the decision of whether to accept or reject a project is based on an estimate of future cash flows; a discount rate or weighted average cost of capital selected to demonstrate a project's risk or costs and finally, the present value of cash inflows minus the present value of cash outflows After the completion of the initial capital budgeting estimates for the Super Project, several important oversights were brought up by Crosby Sanberg, a manager-financial analysis at General Food Corporation.

The original capital budgeting plan for the Super project was conducted on an incremental evaluation basis, and didn't incorporate the costs attributable to an agglomerator and building that would be partially used by the Super project, but had already been attributed to another of the corporation's projects, Jell-O. Mr. Sanberg felt other important costs or expenses were overlooked in the original basis of evaluation as well, and proposed two other methods, a facilities used basis and a fully allocated facilities and costs basis.

Incremental Basis In this approach originally taken by management, only the incremental revenue and fixed capital investment are considered. However the he loss associated with the alternative use options, or opportunity costs for the Jell-O project building and agglomerator being utilized by the Super project, have not been considered, but they should be included.

Facilities-Used Basis This method recognizes that the fixed capital for the Super project needs to be increased to account for the use of Jell-O equipment and facilities.

The proportion on the pro rata share basis of the cost of building and agglomerate (\$453, 000) is added. The overhead costs directly related to the existing facilities should not be subtracted from incremental earnings, because this subtraction will underestimate the incremental earnings since these costs in either case will be incurred.

Fully Allocated Basis This method follows the assumption that with an expansion in business activity there is a corresponding increase in overhead costs.

Using this evaluation method Mr. Sanberg increases were made to overhead costs in year five of the ten year evaluation period. It is important to identify the related cash flow based on the evaluation method selected. We felt the facilities-used basis method was the most accurate method of the three evaluation methods. The reasoning for this decision and other assumptions can be found below. Facilities-Used method: As Mr. Sanberg stated in his memo, “ the facilities-used basis is a useful way of putting various project on a common ground for purposes of relative evaluation.

By including the additional \$453, 000 the actual cost of the Super project is more accurately represented. In response to criticism of the original incremental approach, the Corporate Controller, Mr. J. C. Kresslin brings up several counter points. It is Mr. Kresslin’s belief that the costs for the project are perfectly fine under the incremental analysis and the costs of the existing agglomerator and building being used do not need to be included. His reasoning for this is that both were necessary pieces of the Jell-O project and were already accounted for there.

He believes it does not matter that the agglomerator and building are only partially being used, since the Jell-O project would not have been able to function without them. Thus the costs have already been attributed to them and the additional ROFE figures provided by Mr. Sanberg are irrelevant. It makes much more sense to partially attribute the cost of the agglomerator and building being used to each project, not solely to one. By attributing the cost each project incurs through its use of the facility and equipment it more accurately shows the financial status of each individual project.

While attributing the cost to a single project instead of dividing it between two may not effect the income statement of the business as an entirety, it could certainly effect the approval of the individual projects. Therefore even though the full costs of the agglomerator and the building to be partially used in the Super Project have already been attributed to the Jell-O project, it would be better to review the Jell-O project and change some of the costs over to the Super Project.

Towards the end of his memo, Mr. Kresslin states that, “ I see very little value in looking at the Super Project all by itself. Better we should look at the total situation before and after to see how we fare. ” This statement once again supports the belief that since the cost have already been attributed to another project, which was successful even with the added cost, there is no reason to reattribute them to a new project. This statement sounds like Mr. Kresslin is only trying to serve the best interests of the company. However, by neglecting to include all costs a project incurs, a project may be wrongfully evaluated.

If a projects outcomes are skewed by inaccurate data, a project that should not be allowed to continue may end up being allowed, and could hurt the company. Since the Super project meets the standards set forth for projects by General Foods even after applying the costs originally attributed to the Jell-O project, the company would not be affected as a whole by employing either approach. With the project being accepted regardless of the approach used, the only difference will be in the profits recorded by the Super and Jell-O projects.

If more accurate projections are desired we recommend the use of an approach similar to the facilities based method. Test market expenses These expenses should not be included in the calculation, since they are a sunk cost and have already been expensed to test the feasibility of the Super project. Therefore the test market expenses were removed from the updated version of Exhibit 6 and not included in our calculations. Allocate for overhead costs in the capital budgeting decision Only part of the overhead costs should be included.

These overhead costs are additional expenses that arise from the super project. For overhead costs that are company-wide, we should not include them into the calculation of cash flow. Charges for erosion of Jell-O sales caused by the introduction of Super It was predicted that sales of the new Super product would result in reduced sales of Jello-O products. Therefore we must account for this erosion in Jell-O sales in our calculations. Therefore the changes made to Exhibit 6 include adding \$453, 000 to the net project cost to follow the facilities-used basis.

The \$360, 000 for Test marketing can also be removed. The test marketing expense is a sunk cost, and has already been spent whether the project continues or not. With the updated Exhibit 6 a payback period of just under 8 years can be calculated along with a PBT of just over 33%. To calculate the IRR and NPV of the Super project we then need to find determine the cash flows for the ten year evaluation period. The calculations for these cash flows can be seen in the attached Appendix 1, as well as the resulting value of 7. 252% IRR.