

Investment Appraisal

Editorial

As a follow up to the CDP paper on Investment Appraisal published last month we present a mini case study on the topic for your consideration.

The suggested answer to the case will be published next month, I hope you find the case material a useful exercise.

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This Case Study is based on the business of Hawsker Feeds Ltd an SME that manufactures Animal Feeds.

Its turnover for the current year is budgeted as £1.5m and its budgeted net profit is £0.45m.

You are to assume the role of an assistant accountant and you have been assigned to work for a period of six months with the Management Accountant.

Your response to the Case Study needs to be in the form of a presentation to the management team who are predominantly non-financial managers.

The MD has met recently with his team to discuss a series of capital investment projects each of which involve a capital outlay of £100000. However the supply of capital is limited to £100000.

The company has a desired return on capital of 15% and this is considered to be their cost of capital and it expects projects to pay back in less than three years.

The following information relates to the cash flows from the projects (recently prepared by the management accountant)

| | Projects (£) | | |
|------|----------------------------|-------------------------------|---------------|
| | Fleet of Delivery Vehicles | Modification to Frinding Mill | Grain Dryer |
| Yr 1 | 40000 | 35000 | 45000 |
| Yr 2 | 50000 | 55000 | 45000 |
| Yr 3 | 50000 | 45000 | 45000 |
| Yr 4 | 55000 | 45000 | 45000 |
| Yr 5 | <u>50000</u> | <u>50000</u> | <u>45000</u> |
| | <u>245000</u> | <u>230000</u> | <u>225000</u> |

Define the following terms:

Average Return on Capital
The Payback Period
Net Present Value

Then prepare an appraisal of each project using the following techniques:

Average Return on Capital
Payback Period
Discounted Cash Flow (NPV Method)

Rank the projects and then focussing on the one you consider to be most favourable, discount this project at 25% to determine the IRR – the internal rate of return (this is to be done by both graph and formula method)

Explain fully to management the reasons why you would adopt this investment.

| NPV Factors | 15% | 25% |
|-------------|-------|-------|
| YR1 | 0.870 | 0.800 |
| YR2 | 0.756 | 0.640 |
| YR3 | 0.658 | 0.512 |
| YR4 | 0.572 | 0.410 |
| YR5 | 0.497 | 0.327 |