**Capital Budgeting Decisions**

**Equity Corp.**

Equity Corp. paid a consultant to study the desirability of installing some new equipment. The consultant recently submitted the following analysis:

|  |  |
| --- | --- |
| Cost of new machine | $100,000 |
| Present value of after-tax revenues from operation | 90,000 |
| Present value of after-tax operating expenses | 20,000 |
| Present value of depreciation expenses | 87,500 |
| Consulting fees and expenses | 750 |

The corporate tax rate is 40%. Should Equity Corp. accept the project?

**Declining Market, Inc.**

Declining Market, Inc. is considering the problem of when to stop production of a particular product in its product line. Sales of the product in question have been declining, and all estimates are that they will continue to decline. Capital equipment used to manufacture the product is specialized but can be readily sold as used equipment. If the decision rule for this case says "Keep producing the product as long as its contribution to net earnings is positive" what, if anything, is wrong with that? [Contribution to new earnings, where *t* is the tax rate, is (1 - *t*) (Sales - Variance cost - Depreciation on equipment used to manufacture product).]

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**Demand for DVD Players**

The demand for DVD players is expanding rapidly, but the industry is highly competitive. A plant to make DVD players costs $40 million, has an annual capacity of 100,000 units, and has an indefinite physical life. The variable production cost per unit is $20 and is not expected to change. If the cost of capital is 10%, what is the price of a DVD player?

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**Clean Tooth**

Several years ago, your firm paid $25,000,000 for Clean Tooth, a small, high-technology company that manufactures laser-based cleaning equipment. Unfortunately, due to extensive production line and sales resistance problems, the company is considering selling the division as part of a modernization program. Based on current information, the following are the estimated accounting numbers if the company continues to operate the division:

|  |  |
| --- | --- |
| Estimated cash receipts, next 10 years | $500,000/year |
| Estimated cash expenditures, next 10 years | $450,000/year |
| Current offer for the division from another firm | $250,000 |

Assume

1. The firm is in the 0% tax bracket (no income taxes).
2. There are no additional expenses associated with the sale.
3. After year 10, the division will have sales (and expenses) of $0
4. Estimates are completely certain.

Should the firm sell the division for $250,000?

**Flower City Grocery**

The Flower City Grocery is faced with the following capital budgeting decision. Its display freezer system must be repaired. The cost of this repair will be $1,000 and the system will be usable for another 5 years. Alternatively, the firm could purchase a new freezer system for $5,000 and sell the old one for $500. The new freezer system has more display space and will increase the profits attributable to frozen foods by 30%. Profits for that department were $5,000 in the last fiscal year. The company's cost of capital is 9%. Ignoring taxes, what should the firm do?