Capital Expenditure Decision

Rajesh Bhatt, the production manager of Ritesh Foundries Ltd (RFL) has just come to know that Indus engineering Ltd. (IEL) has recently introduced a new fabrication machine for medium- size foundries. This new model is more efficient than the currently available models. Rajesh thought that if the new machine were economically attractive, he could discuss with general manager of the company the possibility of replacing the existing machine, which his company had bought 10 years ago. He therefore decided to collect the technical and financial information of the machine from IEL.

Jaikumar, the marketing manager of IEL explained the technical features of the machine, and tried to convince him that his company should go for the new model as it was far superior to their existing machine. Rajesh asked him financial details of buying the new model. The machine cost would be Rs 4,00,000. The new machine will be depreciated over its ten year life. There is no salvage value. It is estimated that the new machine will reduce labour costs by Rs 1,00,000 per year. The management believes that there will be no change in other expenses and revenues of the firm due to the machine. The company requires return on investment of 10 per cent. Its rate of tax is 35 per cent.

The company's income statement for the current year is given for other informations.

Income Statement for the current year

Sales		Rs 50,00,000
Costs:		
Materials	Rs 15,00,000	
Labour	Rs 20,00,000	
Factory & Administrative	Rs 4,00,000	
Depreciation	Rs 4,00,000	Rs 43,00,000
Net Income before taxes		7,00,000
Tax (35%)		2,45,000
Earning after Tax		4,55,000

Q. 1 Evaluate the above situation and give advice to management whether the machine should be purchased or not. (Assume discount rate 10%)

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