Finance 1

Opportunity Cost Exercise

[Opportunity Cost Directions.pdf]

In the *Finance 1 Workbook.xlsx*, go to the worksheet tab "OpportunityCost", at the bottom of the Spreadsheet. This exercise will add an additional scenario to the Sunk Cost exercise. It will not take as much time to ponder and "get" the intended principle. The Sunk Cost exercise data is also displayed on the "OpportunityCost" worksheet.

Intended Learnings

This exercise helps you learn:

1. The Basic Rule of Decision Making: Consider only "Future Cash Flows with Vary Between the Alternatives"
2. In financial decision making, <u>to always include opportunity cost</u>.
3. Opportunity Cost is the cost of lost opportunities.
4. Some types of cost are necessary for proper accounting because Accounting needs to depreciate the entire cost of a project.
5. Some additional types of cost should be included when making a financial decision. These are opportunity costs.

Background (repeated)

Conclackinflacker Meds, Inc. (CMI) develops, manufactures, and markets various pharmaceutical products. They have a world-wide list of clients, both retailers and wholesalers of their own one dozen pharmaceutical products and more than 100 off-brand products produced for a variety of labels.

At CMI's aging Rolfson Plant, there is a very small logistics room, for inspecting, packing, boxing, and shipping of their pharmaceutical products. It is small, has old technology, and costly compared with logistics rooms at other CMI plants. You are head of a management team to consider options to improve the cost of logistics.

Scenario B3

This exercise continues the analysis of the proposed CMI logistics facility.

Opportunity Cost Exercise Directions

After the BBO grad convinces the management team that sunk costs should be dropped from the analysis for the purposes of financial decision making, the team is exuberate that the payback become favorable again to proceed with the new facility. However, the BBO grad is not finished. He also mentions the need to include any opportunity cost in the analysis. He asked about the land that was purchased three years ago. The management team hestitates because they had just removed the sunk cost for the land from the analysis. The BBO grad informs them that they MUST include the current, market price of the land in the analysis. If they build the facility CMI looses the OPPORTUNITY TO SELL THE LAND to someone else. This is a Opportunity Cost. It is an increased cost of to the company of building the facility.

The management team reluctantly agrees and obtains appraisals from three reputable commercial appraisers in the area. In averaging these three appraisals, the opportunity COST to the company of building the facility is $600,000.

When this is factored in, what happens to the payback?

Assignment:

1. Unhide the Scenario A by selecting "Unhide" from the pull down menu for Cell O11.
2. Inspect the costs and the total cost line (Row 20), particularly the opportunity cost line in Row 14.
3. Inspect the Savings lines. There are no changes to savings from Scenario B2.
4. Calculate the Payback in Cell O26.
5. Answer Q1 through Q4.

Assumptions

1. Disregard PT/At and DTS.
2. Even though Payback is a flawed valuation tool, this exercise uses it so you can arrive at an answer. Payback will be replaced in BBO Finance 2 with more appropriate tools. This exercise is intended to teach a key principle of cash flowing: In financial decision making, <u>always include opportunity cost</u>. You will use this principle in Finance 2.

Conclusion

Keep these directions on your hard drive. This file is part of the tools you will keep as you complete the BBO course. This may be useful to you on the Final Exam for this course and the Capstone Case in the final BBO course.

Thank you for your work.

