CHAPTER 5

MAKING CAPITAL INVESTMENT DECISIONS

THE NATURE OF INVESTMENT DECISIONS

The essential feature of investment decisions is time. Investment involves making an outlay of something of economic value, usually cash, at one point in time, which is expected to yield economic benefits to the investor at some other point in time. Usually, the outlay precedes the benefits. Also, the outlay is typically one large amount and the benefits arrive as a series of smaller amounts over a fairly protracted period.

INVESTMENT APPRAISAL METHODS

- accounting rate of return (ARR)
- payback period (PP)
- net present value (NPV)
- internal rate of return (IRR).

ACCOUNTING RATE OF RETURN (ARR)

The accounting rate of return (ARR) method takes the average accounting operating profit that the investment will generate and expresses it as a percentage of the average investment made over the life of the project. Thus:

$$\text{ARR} = \frac{\text{Average annual operating profit}}{\text{Average investment to earn that profit}} \times 100\%$$

PAYBACK PERIOD (PP)

The payback period (PP) is the length of time it takes for an initial investment to be repaid out of the net cash inflows from a project. Since it takes time into account, the PP method seems to go some way towards overcoming the timing problem of ARR – or at first glance it does.

NET PRESENT VALUE (NPV)

From what we have seen so far, it seems that to make sensible investment decisions, we need a method of appraisal that both considers all of the costs and benefits of each investment opportunity, and makes a logical allowance for the timing of those costs and benefits. The net present value (NPV) method provides us with this.

INTERNAL RATE OF RETURN (IRR)

This is the last of the four major methods of investment appraisal that are found in practice. It is quite closely related to the NPV method in that, like NPV, it also involves discounting future cash flows. The internal rate of return (IRR) of a particular investment is the discount rate that, when applied to its future cash flows, will produce an NPV of precisely zero. In essence, it represents the yield from an investment opportunity.

MANAGING THE INVESTMENT DECISION

Stage 1: Determine investment funds available

Stage 2: Identify profitable project opportunities

Stage 3: Evaluate the proposed project

Stage 4: Approve the project

Stage 5: Monitor and control the project

QUESTIONS

1. Why is the net present value (NPV) method of investment appraisal considered to be theoretically superior to other methods that are found in practice?
2. The payback method has been criticised for not taking the time value of money into account. Could this limitation be overcome? If so, would this method then be preferable to the NPV method?
3. Research indicates that the IRR method is extremely popular even though it has shortcomings when compared to the NPV method. Why might managers prefer to use IRR rather than NPV when carrying out discounted cash flow evaluations?

REFERENCE

- Atrill, P. & McLaney, E. Management Accounting for Decision Makers (6th ed). https://www.drnishikantjha.com/booksCollection/Management%20Accounting%20(%20PDFDrive%20)%20(2).pdf