

accounting rate of return and payback period

Accounting Rate of Return and Payback Period: A Comprehensive Analysis

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Introduction:

The accounting rate of return (ARR) and payback period are two widely used, yet often criticized, capital budgeting techniques. While relatively simple to calculate, their limitations need careful consideration. This article provides a thorough examination of both methods, highlighting their strengths, weaknesses, and appropriate applications. Understanding the nuances of accounting rate of return and payback period is crucial for making sound investment decisions.

1. Understanding the Accounting Rate of Return (ARR)

The accounting rate of return, also known as the average rate of return, measures the average annual profitability of an investment as a percentage of the average investment. It's calculated by dividing the average annual profit by the average investment.

Formula: $ARR = (\text{Average Annual Profit} / \text{Average Investment}) \times 100$

The average annual profit is typically the total profit over the project's life divided by the number of years. The average investment is often calculated as $(\text{Initial Investment} + \text{Salvage Value}) / 2$.

Opportunities of using ARR:

Simplicity: ARR is straightforward to calculate and understand, making it accessible to individuals with limited financial expertise.

Profitability Focus: It directly focuses on profitability, a key concern for most businesses.

Easy Comparison: ARR allows for easy comparison of different investment projects based on their projected profitability.

Challenges of using ARR:

Ignores Time Value of Money: ARR fails to consider the time value of money, a critical factor in investment appraisal. A dollar received today is worth more than a dollar received in the future due to its potential earning capacity.

Arbitrary Cut-off Rate: The decision of whether to accept or reject a project based on ARR often relies on an arbitrarily chosen minimum acceptable rate of return, which can be subjective.

Dependence on Accounting Methods: The calculated ARR is heavily influenced by the accounting methods used, leading to potential inconsistencies and biases.

1. Understanding the Payback Period

The payback period measures the time it takes for an investment to generate enough cash inflow to recover its initial cost. It's a simple measure of liquidity risk.

Formula: $\text{Payback Period} = \text{Initial Investment} / \text{Annual Net Cash Inflow}$

If the annual net cash inflow is not constant, a cumulative cash flow approach is used.

Opportunities of using Payback Period:

Simplicity and Ease of Use: Like ARR, the payback period is easy to calculate and understand.

Liquidity Focus: It emphasizes the speed of recouping the initial investment, which is crucial for businesses with liquidity constraints.

Risk Management: A shorter payback period indicates lower risk, as the investment is recovered quicker.

Challenges of using Payback Period:

Ignores Cash Flows Beyond the Payback Period: The payback period completely ignores cash flows occurring after the initial investment is recovered, potentially leading to the rejection of highly profitable long-term projects.

Ignores Time Value of Money: Similar to ARR, the payback period doesn't

account for the time value of money.

Arbitrary Cut-off Point: The acceptance or rejection of a project is based on an arbitrarily chosen maximum acceptable payback period.

1. Comparing ARR and Payback Period

Both ARR and payback period are simple to calculate and understand, making them appealing for quick assessments. However, their failure to consider the time value of money is a significant limitation. More sophisticated methods, such as Net Present Value (NPV) and Internal Rate of Return (IRR), address this issue and provide a more comprehensive evaluation of investment opportunities.

1. When to Use ARR and Payback Period

Despite their limitations, ARR and payback period can be valuable tools in specific situations:

Preliminary Screening: They can be used as initial screening tools to quickly eliminate obviously unsuitable projects.

Projects with Similar Risk Profiles: When comparing projects with similar risk profiles, ARR and payback period can offer a simplified comparative analysis.

Liquidity Constraints: Payback period is particularly useful for businesses facing severe liquidity constraints, as it highlights projects that quickly recover their initial investment.

Conclusion:

The accounting rate of return and payback period offer a simplified approach to investment appraisal, providing quick insights into profitability and liquidity. However, their failure to account for the time value of money and their reliance on arbitrary cut-off points are major drawbacks. While they might be useful for preliminary screening or in specific contexts, they should not be the sole basis for making significant investment decisions. More sophisticated techniques, such as NPV and IRR, should be employed for a complete and accurate evaluation. A balanced approach, combining these simpler methods with more rigorous techniques, will lead to better investment decisions.

FAQs:

1. What is the difference between ARR and ROI? While often used interchangeably, ARR is a specific calculation using average annual profits and average investment, whereas ROI can encompass various methods of calculating return on investment.
1. How do I account for inflation when using ARR or Payback Period? You should adjust the cash flows for inflation before calculating ARR or Payback Period.
1. What are the limitations of using the payback period method? It ignores the time value of money, cash flows beyond the payback period, and relies on an arbitrary cutoff.
1. Can I use ARR and Payback Period together? Yes, using both methods can provide a more comprehensive view, though neither should be the sole decision-making factor.
1. What is a desirable ARR? A desirable ARR depends on the industry, risk, and the opportunity cost of capital. It's usually compared to a hurdle rate set by the company.
1. How do I calculate average investment for ARR? Typically, it's $(\text{Initial Investment} + \text{Salvage Value}) / 2$.
1. What are some alternatives to ARR and Payback Period? Net Present Value (NPV), Internal Rate of Return (IRR), Discounted Payback Period.
1. How does the payback period help in risk management? A shorter payback period indicates lower risk as the initial investment is recovered sooner.

1. Is it possible to have a negative ARR? Yes, if the average annual profit is negative, resulting in a negative ARR.

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