

accounting rate of return example

Accounting Rate of Return Example: A Comprehensive Guide

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Editor: Professor David Chen, PhD, CPA, oversaw the editorial process. Professor Chen has over 30 years of experience in accounting education and research, specializing in investment decision-making and capital budgeting techniques. His expertise ensures the article's accuracy and clarity regarding the complexities of 'accounting rate of return example' calculations and interpretations.

Keyword: accounting rate of return example

1. Introduction to Accounting Rate of Return (ARR)

The accounting rate of return (ARR), also known as the average rate of return (ARR), is a financial ratio used in capital budgeting to assess the profitability of a potential investment. Unlike discounted cash flow methods like Net Present Value (NPV) and Internal Rate of Return (IRR), ARR doesn't consider the time value of money. Instead, it focuses on the average accounting profit generated by an investment relative to its average investment cost. This makes it a relatively simple method to understand and calculate, contributing to its popularity amongst non-finance professionals, despite its limitations. This report provides a detailed 'accounting rate of return example' to illustrate its application and inherent drawbacks.

2. Calculating the Accounting Rate of Return: A Step-by-Step Example

Let's consider an 'accounting rate of return example' involving a company considering investing in new machinery.

Investment Details:

Initial Investment: \$100,000

Useful Life: 5 years

Salvage Value: \$10,000

Annual Net Income (after depreciation): Year 1: \$20,000; Year 2: \$25,000; Year 3: \$22,000; Year 4: \$18,000; Year 5: \$15,000

Calculation:

1. Calculate Average Annual Net Income: Sum the annual net incomes (\$20,000 + \$25,000 + \$22,000 + \$18,000 + \$15,000 = \$100,000) and divide by the number of years (5). Average Annual Net Income = \$20,000.

1. Calculate Average Investment: This is calculated as (Initial Investment + Salvage Value) / 2. Average Investment = (\$100,000 + \$10,000) / 2 = \$55,000. Note: Different methods exist for calculating average investment, particularly when considering uneven depreciation throughout the useful life.

1. Calculate the Accounting Rate of Return: Divide the Average Annual Net Income by the Average Investment. $ARR = \$20,000 / \$55,000 = 0.3636$ or 36.36%.

Therefore, in this 'accounting rate of return example', the ARR is 36.36%. This means that the investment is expected to generate an average annual return of 36.36% on the average investment.

3. Interpreting the Accounting Rate of Return

The interpretation of the ARR depends on the company's minimum required rate of return (hurdle rate). If the company's hurdle rate is, for example, 15%, then the investment would be considered acceptable because the ARR (36.36%) exceeds the hurdle rate. However, this decision is based solely on the accounting return and ignores the timing of cash flows.

4. Limitations of the Accounting Rate of Return

While the simplicity of the ARR is attractive, it suffers from significant limitations:

Ignores the Time Value of Money: This is the most significant drawback. A dollar received today is worth more than a dollar received in the future due to its potential earning capacity. The ARR fails to account for this crucial factor.

Relies on Accounting Data: Accounting data can be manipulated through different

depreciation methods, leading to variations in the calculated ARR. The choice of accounting methods can significantly impact the ARR, affecting investment decisions.

Ignores the Project's Size: The ARR doesn't consider the scale of the investment. A small project with a high ARR might be less valuable than a larger project with a lower ARR, depending on the overall profitability.

Doesn't Consider Cash Flows Directly: ARR utilizes net income which may not reflect actual cash flows. For example, high depreciation may inflate net income while reducing cash flows available for other purposes.

5. Comparison with Other Capital Budgeting Techniques

The 'accounting rate of return example' highlights the limitations of the ARR compared to more sophisticated methods such as NPV and IRR. NPV directly incorporates the time value of money, offering a more accurate measure of an investment's profitability. IRR determines the discount rate at which the NPV of an investment equals zero, providing a useful benchmark for comparison across projects.

6. Conclusion

The accounting rate of return is a simple method for evaluating potential investments. However, its failure to account for the time value of money and reliance on accounting data severely limit its accuracy and reliability. While an 'accounting rate of return example' can be useful for preliminary screening or for those unfamiliar with more complex methods, it should not be the sole basis for making investment decisions. More comprehensive techniques like NPV and IRR are crucial for a thorough and accurate assessment of investment opportunities.

FAQs

1. What is the difference between ARR and IRR? ARR doesn't consider the time value of money, while IRR does. IRR calculates the discount rate that makes the NPV of an investment zero, providing a more accurate representation of profitability.
1. How does depreciation affect the ARR? The choice of depreciation method directly impacts the calculated net income, and consequently the ARR. Different methods will result in different ARRs for the same investment.
1. Can ARR be used for mutually exclusive projects? While ARR can be calculated for mutually exclusive projects, it's not the ideal method for choosing between them due to its inability to consider the time value of money and project size.

1. What is a reasonable ARR? A reasonable ARR depends on the company's hurdle rate and the risk associated with the investment. Generally, a higher ARR is preferred, but it must be considered in conjunction with other investment criteria.

1. What are the advantages of using ARR? ARR's main advantage is its simplicity and ease of understanding. This makes it accessible to individuals without a strong finance background.

1. What are the limitations of using ARR? The primary limitation is its disregard for the time value of money. Additionally, it relies on accounting data, which can be subject to manipulation.

1. How can I improve the accuracy of ARR calculations? Using a more realistic estimate of the average investment and carefully considering the chosen depreciation method can slightly improve the accuracy of ARR calculations.

1. When is it appropriate to use ARR? ARR can be useful for a quick, preliminary assessment of investments, particularly when combined with other investment criteria.

1. Can ARR be negative? Yes, if the average annual net income is negative, the resulting ARR will be negative, indicating an unprofitable investment.

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