accounting rate of return vs internal rate of return

Accounting Rate of Return vs. Internal Rate of Return: A Comprehensive Analysis

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Publisher: Wiley Finance

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Professor David Chen holds a PhD in Accounting from Harvard University and has extensive experience editing scholarly publications in the field of finance. His expertise ensures the accuracy and clarity of the presented information regarding accounting rate of return vs. internal rate of return.

Keywords: accounting rate of return, internal rate of return, ARR, IRR, capital budgeting, investment appraisal, profitability analysis, discounted cash flow, return on investment, project evaluation

1. Introduction: Understanding the Need for Project Evaluation

Businesses constantly face decisions about allocating capital to new projects. Choosing the right projects is crucial for maximizing shareholder value. Two prominent methods for evaluating the profitability of potential investments are the accounting rate of return (ARR) and the internal rate of return (IRR). This analysis delves into the strengths and weaknesses of accounting rate of return vs. internal rate of return, exploring their historical context and continued relevance in modern finance.

2. Accounting Rate of Return (ARR): A Simple Approach

The ARR, also known as the average rate of return, is a simple method that calculates the average annual net income generated by a project as a percentage of the average investment. It's calculated as:

ARR = Average Annual Net Income / Average Investment

The average annual net income is the sum of the project's net income over its lifespan, divided by the number of years. The average investment is typically the sum of the initial investment and the salvage value (if any), divided by two.

Historical Context: ARR has been used for decades as a straightforward way to assess project profitability, particularly appealing to managers less familiar with sophisticated financial techniques. Its simplicity makes it easily understandable and communicable.

Advantages of ARR:

Simplicity: Easy to calculate and understand.
Intuitive: Directly relates profit to investment.
Useful for comparing projects with similar lifespans: Facilitates relative comparisons within a specific timeframe.

Disadvantages of ARR:

Ignores the time value of money: A major flaw, as it doesn't discount future cash flows.
Relies on accounting profits, not cash flows: Accounting profits can be manipulated, leading to inaccurate results.
Doesn't consider the project's lifespan: A short-lived, highly profitable project might have a lower ARR than a long-lived, less profitable one.

3. Internal Rate of Return (IRR): A Discounted Cash Flow Approach

The IRR is a more sophisticated method that uses discounted cash flow (DCF) analysis. It represents the discount rate that makes the net present value (NPV) of a project equal to zero. In simpler terms, it’s the rate of return that the project is expected to generate.

Historical Context: The development of the IRR method is closely tied to the increased understanding of the time value of money in financial decision-making. Its adoption accelerated with the growing availability of computing power, making the complex calculations more manageable.

Advantages of IRR:

Considers the time value of money: Accurately reflects the present value of future cash flows.
Based on cash flows: Uses actual cash inflows and outflows, less susceptible to accounting manipulation.
Provides a single percentage rate: Allows for easy comparison across projects with different sizes and lifespans.

Disadvantages of IRR:

Complexity: Requires more complex calculations compared to ARR.
Multiple IRRs: Possible in projects with unconventional cash flow patterns.
Can be misleading with mutually exclusive projects: Ranking projects solely on IRR may lead to incorrect choices if projects have different initial investments or lifespans.

4. Accounting Rate of Return vs. Internal Rate of Return: A Direct Comparison

The fundamental difference between accounting rate of return vs. internal rate of return lies in their treatment of the time value of money. IRR explicitly accounts for it, while ARR ignores it. This crucial difference often leads to conflicting results, particularly when comparing long-term projects with varying cash flow patterns. The IRR is generally considered a superior method because of its incorporation of the time value of money, a cornerstone principle of modern finance.

5. Current Relevance of ARR and IRR

Despite the theoretical superiority of IRR, ARR still holds some relevance. Its simplicity makes it useful for initial screening of projects or for situations where detailed cash flow projections are unavailable. However, for major investment decisions, IRR remains the preferred method due to its accuracy and consideration of time value of money. Many organizations use both methods, utilizing ARR as a preliminary check before applying the more rigorous IRR analysis. The choice between accounting rate of return vs. internal rate of return ultimately depends on the specific context, data availability, and the decision-maker's comfort level with financial modeling.

6. Conclusion

In the ongoing debate of accounting rate of return vs. internal rate of return, the IRR emerges as the superior method for evaluating capital projects. While ARR offers simplicity, its neglect of the time value of money significantly limits its accuracy. IRR, although more complex, provides a more comprehensive and reliable assessment of project profitability, considering the timing and magnitude of cash flows. Modern financial analysis emphasizes the use of IRR and other discounted cash flow techniques for informed capital budgeting decisions.

FAQs

1. Which method is better for evaluating mutually exclusive projects? Modified IRR (MIRR) or NPV analysis are generally preferred over simply comparing IRRs for mutually exclusive projects.

1. Can ARR be used for projects with uneven cash flows? Yes, but the calculation of average annual net income becomes more complex.

1. What are the limitations of using only IRR for investment decisions? IRR can lead to incorrect choices when comparing projects with different lifespans or initial investments. NPV is a more comprehensive evaluation criterion.

1. How can I calculate the average investment for ARR? The average investment is typically calculated as (Initial Investment + Salvage Value)/2.

1. What is the impact of inflation on ARR and IRR calculations? Both methods can be adjusted to account for inflation by using real (inflation-adjusted) cash flows.

1. What is the relationship between IRR and NPV? A positive NPV indicates an IRR greater than the cost of capital, while a negative NPV signifies an IRR less than the cost of capital.

1. Can ARR be used to evaluate projects with negative cash flows? Yes, but it can lead to misleading results, especially if the negative cash flows are significant.

1. How does risk affect the choice between ARR and IRR? Risk-adjusted discount rates should be used in IRR calculations to account for project risk. ARR does not inherently account for risk.

1. What software can I use to calculate IRR and ARR? Many spreadsheet programs (like Excel) and financial calculators can easily compute both ARR and IRR.

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