Chapter 10 Investment Appraisal

Key terms

1. Average rate of return or accounting rate of return(ARR): a method of investment appraisal that measures the net return per annum as a percentage of the initial spending.
2. Capital cost: the amount of money spend when setting up a new venture.
3. Cash inflow: the cash coming into the business such as that from sales or bank loans
4. Cash outflow: the cash going out of business when payments are made to workers or suppliers, for example.
5. Discounted cash flow(DCF): a method of investment appraisal that takes interest rates into account by calculating the present value of future income.
6. Investment: the purchase of capital goods.
7. Investment appraisal: the evaluation of an investment project to determine whether or not it is likely to be worthwhile.
8. Net cash flow: cash inflows minus cash outflows
9. Net present value(NPV): the present value of future income from an investment project, minus cost.
10. Opportunity cost: when choosing between different alternatives, the opportunity cost is the benefit lost from the next best alternative to the one that has been chosen.
11. Payback period: the amount of time it takes to recover the cost of an investment project.
12. Present value: the value today of a sum of money available in the future.
13. Qualitative: represented by words.
14. Quantitative: represented by numbers.

1. Investment : refers to the purchase of capital goods e.g. a building contractor buys a cement mixer.

Investment appraisal: how a business might evaluate an investment project to determine whether or not it is likely to be profitable.

2. Simple payback

- **Payback period;** refers to the amount of time it takes for a project to recover

3. Average (Accounting) Rate of Return (ARR)

- The average rate of return or the accounting rate of return method.
- Measures the net return each year as a percentage of the capital cost of investment.

$$\text{Average Rate of Return (ARR)} = \frac{\text{Net return(Profit) per annum}}{\text{Capital outlay cost}} \times 100$$

Advantages of ARR method

1. It shows clearly the profitability of an investment project.
2. The rate of return can be compared to other uses for investment funds.

4 Discounted cash flow (Net present value NPV)

- Payback & ARR methods do not take into account the time valve of money.
- Discounted cash-flow technique; money in the future is worth less than the same amount now (present value).

Advantages of discounted cash flow method

1. It is calculated in present value.
2. The discount rate used can be changed as risk and conditions in financial market charge.