Capital Investment Appraisal – Advantages & Disadvantage of Different Methods

PAYBACK PERIOD

Advantages:

- Easy to calculate and to understand – it gives an immediate view on how long it will take to recoup an investment
- Helps to identify how quickly the cash flow might become positive on the project – useful
- Less uncertainty/risk (the quicker that money is recouped, the less risk)

Disadvantages:

- Ignores all cash flows after the payback period
- Ignores the timings of cash flows within the payback period
- Ignores the time value of money (i.e. money now can earn interest)

ACCOUNTING RATE OF RETURN

Advantages:

- Easy to calculate and easy to understand
- Relates to the profits shown in the annual accounts
- Takes account of profits earned over the entire life of the project
- Popular with some businesses because of its simplicity

Disadvantages:

- Ignores the time value of money (i.e. money now can earn interest)
- Since it uses averages, it takes no account of the timing of profits
- It takes no account of the different lives of projects
- The calculation of profits is subject to different accounting policies, e.g. depreciation
- No agreed method of calculating ARR

DISCOUNTED CASH FLOW TECHNIQUES (NPV & IRR)

Advantages:

- Recognise the time value of money
- Takes account of cash flows over the whole life of the project
- Makes comparability with alternative uses of money easier

Disadvantages:

- The concept is difficult for some people to understand
- It depends on being able to ascertain the correct cost of capital
- Interest may adversely change