

# Internal rate of return analysis



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In investment decision analysis you may need to calculate internal rate of return. “ Internal rate of return (IRR) is the discount rate that gives the project a zero NPV” (McLaney, 2006). It is a good choice to use for investment projects. There is a formula for the internal rate of return:

(A is the lower discount rate and B is the higher rate, a is the NPV at the lower rate and b is the NPV at the higher rate.) For example the Net Present Value (NPV) is 88 when the discount rate is 20%, and the NPV is 12 when the discount rate is 30%. Therefore the IRR in this situation is 28. 8%. The consequence should be compared with the rate of return which the company’s required. If the IRR higher than that, the project should be accepted otherwise it will not be accepted.

From our lecturer Linda’s lectures we knew that there are some advantages and disadvantages. The internal rate of return is simple to interpret and calculate which more easily understand than some other methods; and it is good if it uses with NPV. However there are some drawbacks as well: the output is a percentage rather than the physical size of the earnings; it may produce more than one rate of return which may make the user confused; some managers may not familiar with this method and it is difficult to calculate by hand. The internal rate of return approach is usually used for a corporation’s investment.

NPV and IRR take full account of cash flows and the time value of money. When we use NPV to decide whether the project will be accepted or not, the condition is that NPV should above 0. Otherwise the investment should be rejected. In the same situation, it is better to use the project which NPV is

higher than others. However if we use IRR approach, the rate should be higher than what the company requires. Eddie McLaney (2006) mentioned that IRR cannot deal with different required rates of return which Pike, R & Neale, B (2006) have pointed out in four areas: mutually exclusive projects, percentage returns, the unconventional cash flows, and reinvestment assumptions. And the project should be independent otherwise IRR may fail.

### Capital Allowances

Some businessperson complained about business tax, but there are some ways to encourage their investment. As a business you can claim tax allowances, called capital allowances. Eddie McLaney (2006) explained that capital allowances are when a company makes investments in plant or machinery they can often claim an allowance on their tax change for the period. Companies can use capital allowances on their plant, machinery, certain building works, and research and development.

It is obviously to know that capital allowances can help a company to reduce taxation. And the rate, when and how to calculate, and the amount of a company's capital allowances depend on what they are claiming for.

However there are different rules should be obeyed within different types of capital allowances.

### References

[http://www.bytestart.co.uk/content/taxlegal/9\\_6/capital-allowances.shtml](http://www.bytestart.co.uk/content/taxlegal/9_6/capital-allowances.shtml)

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