Accounting rate of return

The accounting rate of return (ARR) is a way of comparing the profits you expect to make from an investment to the amount you need to invest. The ARR is normally calculated as the average annual profit you expect over the life of an investment project, compared with the average amount of capital invested. For example, if a project requires an average investment of ? 100, 000 and is expected to produce an average annual profit of ? 15, 000, the ARR would be 15 per cent.

The higher the ARR, the more attractive the investment is. You can compare the ARR to your own target rate of return, and to the ARR on other potential investments. The ARR is widely used to provide a rough guide to how attractive an investment is. The main advantage is that it is easy to understand. Disadvantages Unlike other methods of investment appraisal, the ARR is based on profits rather than cashflow. So it is affected by subjective, non-cash items such as the rate of depreciation you use to calculate profits.

The ARR also fails to take into account the timing of profits. In calculating ARR, a ? 100, 000 profit five years away is given just as much weight as a ? 100, 000 profit next year. In reality, you would prefer to get the profit sooner rather than later. See the page in this guide on discounting future cashflow. There are also several different formulas that can be used to calculate an ARR. If you use the ARR to compare different investments, you must be sure that you are calculating the ARR on a consistent basis.