

Internal rate of return



Many companies want to have a return on their investment in a few years and begin to evaluate their projects optimistically calculating an internal rate of return not yielding results in the end. This does not end up being expected by the companies; according to the article the authors John C. Keller and Justine J. McCormick. They suggest that there is a tendency to a risky behavior, companies started to run the risk of creating unrealistic numbers for themselves and shareholder expectations, which it could confuse communications with investors and inflating managerial rewards.

This confronts us with a real and serious problem when it comes to investing in projects because later we can not generate the expected return and risk. In the project, the IRR can generate two different values for the same project when future cash flows switch from negative to positive (or positive to negative). In addition, since the IRR is expressed as a percentage, and this can make small projects appear more attractive than large, although large projects with lower IRR may be more attractive as NPV of smaller projects with IRR.

The management of the IRR must be just when the project generates no interim cash flows - or when those interim cash flows really can be invested in real IRR otherwise would not be realistically analyzing the viability of the project, and this is not what you want if you really are expecting to thrive in a project, the best you can do is to get real results that can assess the potential risks of the investment and the real return of the project.

Among its disadvantages we can find that requires finally are compared with an opportunity cost of capital to determine the decision on the project. That

project in which the internal rate of return, we will accept it greater than the discount rate investor (relevant Interest rate), the AIR criterion is not reliable to compare projects and only tells us whether a project is better than the alternative profitability. The AIR, only evaluates local impacts that do not necessarily impact the company as a whole system, which aims to make more money.

The AIR is important to calculate the profitability of resources. The VPN allows feasibility analysis, when this indicator is positive projects are attractive and allows optimizing resources when the project has a higher NP than others. The AIR, only evaluates the feasibility, when this is greater than the rate of chance, but definitely does not optimize resources. When you are evaluating projects for enterprise systems for profit, the criterion to be used, is the VPN.

In non-profit companies, the appropriate criterion may be the AIR, because it allows to identify the financial feasibility and optimization of resources, meets the criteria or indicators of social evaluation, where the owner of the project, the population is required greatest need and urgency. Taking into account the point of views of the authors we have to mention something important, and that is when the cost of capital is used, the true annual equivalent yield of a project can be significantly reduced - again, especially with projects they reported high Minimal IRS.

When executives review projects with IRS that are close to cost of capital of a are not particularly real because the rate distortion reinvestment is more noticeable precisely when managers tend to think that their projects are

more attractive. In conclusion, the simplest way to avoid problems with the AIR, is not use it to calculate profitability of projects because we do not want to invest on wrong assumptions, no matter whatever it's used to review projects, it is important that projects are based on real and figures close to the company objectives.

This is important to achieve the desired performance as stakes and risk capital investment, An option can be for small projects because it is the most practical thing to do, but for big projects it is recommended not to fall into this kind of assumptions not realistic to avoid disappointment, you must learn to avoid the risk and not be tempted by fast optimistic estimates or investment returns that does not show us the big picture, Executives should use at least a modified internal rate of return.

It is better if they use MIR to calculate the profitability because It allows users to set rates more realistic interim reinvestment and therefore to calculate a true annual equivalent yield, Other aspect to consider is whether the internal rate of return is greater than the discount rate, the project should be accepted as a higher yield that estimated the minimum required, but you can do this just when the net cash flows are reinvested. You should think, if the internal rate of return is less than the discount rate, the project should be rejected because lower yield estimates is the minimum required.