Appendix 1: The Accounting Rate of Return

The ARR method of capital investment appraisal appears to go under a number of guises, with a multitude of definitions used as the basis for its calculation. There is no single accepted formula for the accounting rate of return (ARR), and there is considerable confusion in the academic and the professional literature as to which method of calculation should be adopted. As a result, management may select whichever formula suits them best.

Reference is made to the ARR without giving a precise definition to its calculation or meaning. Comparisons are made on the basic assumption that one is comparing like with like. This, in many cases, is a false assumption. Although, in some cases, a distinction is made between the ARR based on initial investment and average investment, there is no generally accepted basis of calculating the figures to be used for either investment in or the return arriving from a project.

The accounting rate of return (ARR) is also commonly referred to as average rate of return (ARR), return on investment (ROI), and return on capital employed (ROCE). It is also known as average book rate of return, return on book value, book rate of return, unadjusted rate of return, and simple rate of return. In many cases the terms are used synonymously, while in others, they imply subtle differences in calculation.

Although the ARR, in whatever format, suffers from serious deficiencies (it is based on an accrual and not a cashflow concept; it does not take fully into account the fact that profits may vary year by year and therefore show an uneven pattern; it ignores the time value of the flow of funds and is not suitable for comparing projects with different life spans), research shows that it continues to be used in the United Kingdom and the United States for the appraisal of capital projects. Reasons
Appendix 1: The Accounting Rate of Return

183

for its use have been given as simplicity and ease of calculation, readily understandability, and its use of accrual accounting measures by which managers are frequently appraised and rewarded. It does, however, offer a potential for manipulation by creative accounting.

Under the ‘initial’ method, the returns from a project are expressed as a percentage of the initial cost (hence the term ‘initial’). The returns are stated after depreciation, so this shows in effect, in a simplistic way, the rate of return that is expected to be achieved above that which is required to recover the initial cost of the investment. There is, however, a school of thought that advances the proposition that as the capital investment will be written-off over the useful life of the project, then the figure for investment should take this into account. In its most basic form, this would result in an ‘average’ investment figure of one-half of the original cost. The earnings from the project would remain the same under either approach.

There appears to be two further areas of confusion with regard to the calculation of the ARR: how to deal with (i) scrap/salvage values and (ii) different methods of depreciation. Some textbooks show examples that do not include scrap values, thus getting round the problem of what to do with them, and with regards to depreciation, restrict the calculations to straight-line depreciation. This gives the reader of such texts a general impression of incompleteness, in that he/she is left wondering what to do if there is any scrap value from a project or if the organisation uses a different method of depreciation other than the straight-line method.

Suggestion

We would suggest that the accounting rate of return (ARR) used in the evaluation of capital projects should be based on either the initial (with the abbreviation, ARR_i) or average (ARR_ave) investment method.

The term ‘accounting’ relates to the concept by which the determination of the actual figures for income and investment are arrived at. The figure for income should be calculated following the conventional accounting concepts for profit. In this case, income is synonymous with profit. Net income should be after depreciation. By using the following formula, it is immaterial which method of depreciation is used, as the average income will always be total gross income less total depreciation divided by the life (in years) of the project. Total depreciation will be equal to the capital cost of the project less any scrap value. Investment under the ‘initial’ method will be the capital cost of the project less any
scrap value, while under the ‘average’ method, it will be the capital cost of the project plus any scrap value divided by 2.

\[
\text{Average income} = \frac{\text{Total gross income} - \text{Total depreciation}}{\text{Life of project}}
\]

**Investment:**

1. ‘Initial’ investment = Capital cost of project less scrap value.
2. ‘Average’ investment = (Capital cost of project plus scrap value)/2

\[
\text{ARR}_i = \frac{\text{Average income} \times 100}{\text{Initial investment}}
\]

\[
\text{ARR}_a = \frac{\text{Average income} \times 100}{\text{Average investment}}
\]

Once the ARR has been calculated, the figure is compared with a predetermined hurdle rate to see if the project is ‘acceptable’. If the ARR is greater than the hurdle rate, then the project has satisfied this particular financial criterion of investment appraisal.

**Our favoured approach to the calculation of ARR**

In our opinion, it seems unnecessary to refine the calculations any further. After all, the figures for both investment and income are based on management estimates and are therefore susceptible to errors. Much of the confusion would also disappear if the term ‘ARR’ (ARR\(_i\) and ARR\(_a\)) was restricted to capital investment appraisal, and ROI and ROCE are treated as post-investment ‘performance measures’.

ROI, which appears to be more widely used in the United States than in the United Kingdom, should be applied to the appraisal of ‘performance’ and calculated on an annual basis, based on the net book value of the investment at the beginning of each year.

Because of the difficulty and information cost in determining the actual ‘profit’ from each individual investment made by an organisation, it may be more appropriate to calculate the ROI on a profit centre basis.

The ROCE is more appropriate in measuring divisional performance, rather than as a tool for the initial evaluation of capital projects. It differs from both the ARR and ROI, in that it includes ‘working capital’ as part of the investment figure, and from the ARR in that it is calculated on an annual basis and does not therefore show, as a single figure, the overall return from a project.
The ROCE is the ratio of accounting profit to capital employed expressed as a percentage. Accounting profit is arrived at after taking into account depreciation, while capital employed is the capital cost of the investment plus additional working capital required as a result of the project less accumulated depreciation.

Although the ROI and ROCE are post-investment performance measures, it is understandable that managers may wish to know how these measures will be influenced by accepting a particular investment project. After all, their own performance will, in many cases, be judged using one of these performance measurements, and they will, invariably, be rewarded accordingly.

It is therefore not surprising that managers may wish to calculate such figures when appraising capital projects. What must be remembered, however, is that the ROI and ROCE calculate the annual return from an investment or group of investments, and it is the returns ‘profile’ that will be of interest to management. Selecting projects with different profit profiles will influence the total annual profit from all investments. The profit profile will not only be influenced by the pattern of gross income from investments but also by the method of depreciation adopted by the organisation.

It can be seen that by adopting the reducing-balance method of depreciation, this has the effect of showing lower profits in the early years and higher profits in later years, while the straight-line method of depreciation charges the same amount to costs in each year. The ROI and ROCE should not be the driving force behind project selection, as such techniques may be biased towards managerial benefits and short-termism rather than corporate long-term profitability.

All other ‘terms’ for ARR should be ignored and left out of future textbooks, as they only breed confusion in the minds of both students and practitioners. This is, perhaps, a ‘back to basics’ approach, but one which, in our opinion, would eliminate much of the mystique and confusion over the ARR. It must be remembered that the ARR is a basic, simplistic investment appraisal tool. So why try and make it into something that it will never be—a substitute for the more sophisticated DCF methods?

This is not to say that the ARR has no place in the appraisal of capital investments, for any information is useful. Its use, however, must be made in the right context, and its limitations must be made known to the decision-makers. As part of a set of investment tools, the ARR can provide information that will give a wider perspective to the appraisal of capital projects. But the technique should not be used as the sole criteria for selection, or confused with the ROI or ROCE.
Example

The following example will illustrate the detailed workings of the ARR_i, ARR_a, ROI, and ROCE. A company is considering the investment in a project, the financial details of which are:

- Capital cost of project (cost of plant and installation): £51,435
- Additional working capital required to finance stock and debtors: £4,565
- Estimated useful life of project: 5 years.
- Scrap value of plant less cost of removing from site: £4,000
- Depreciation method used by organisation: 40% on reducing balance.
- Gross income from project: year 1: £20,000; year 2: £25,000; year 3: £20,000; year 4: £15,000; year 5: £7,000.

Calculation of the accounting rate of return

\[
\text{Average net income} = \frac{(\£87,000 - \£47,435)}{5} = \£7,913
\]

\[
\text{Investment (initial method)} = \£51,435 - \£4,000 = \£47,435
\]

\[
\text{Investment (average method)} = \frac{(\£51,435 + \£4,000)}{2} = \£27,718
\]

\[
\text{ARR_i} = \left(\frac{\£7,913}{\£47,435}\right) \times 100 = 16.68\%
\]

\[
\text{ARR_a} = \left(\frac{\£7,913}{\£27,718}\right) \times 100 = 28.55\%
\]

Calculation of the ROI and ROCE

As the ROI and ROCE are annual performance measures, the second year of the project has been selected for the purpose of illustration (it could equally have been any of the other years of the project). As both these methods show the return for a particular year, and not for the project as a whole, the calculations will be influenced by the depreciation method used by the organisation.

ROI for year 2

\[
\text{Net Income for year 2} = \£25,000 - \£12,344 \text{ (second-year depreciation)} = \£12,656
\]

\[
\text{Investment figure} = \£30,861 \text{ (book value at beginning of second year)}
\]

\[
\text{ROI} = \left(\frac{\£12,656}{\£30,861}\right) \times 100
\]

ROI for year 2 = 41.01%
Appendix 1: The Accounting Rate of Return

ROCE for year 2

Net Income for year 2 = £12,656 (same as ROI)

Investment figure = £30,861 + £4,565 (working capital increase)

ROCE = (£12,656/£35,426) × 100

ROCE for year 2 = 35.73%
Appendix 2: Calculating the Modified Internal Rate of Return from the Net Present Value

The two principal discounted cashflow models of capital investment appraisal – the net present value (NPV) and the internal rate of return (IRR) have traditionally been in direct competition, with academics favouring the NPV and practitioners favouring the IRR. These two models have intrinsic differences from each other, with the NPV being an economic indicator and the IRR a financial indicator of a capital investment. Textbooks show the two approaches being calculated independently of each other, although the same cashflows are used in each case. To overcome some of the perceived problems of the IRR, a modified internal rate of return (MIRR) was developed. This appendix shows a simplified way of calculating a project’s MIRR through the net present value profile (NPVP), giving a clear link between the NPV and MIRR.

In its basic form, the NPV of a project is the sum of all the net discounted cashflows during the life of the project less the present value of the capital cost of the project. A positive NPV indicates that if the project is accepted, then the organisation’s wealth will increase by this NPV. If the NPV is negative, then the result will be a reduction in an organisation’s net worth, while a zero NPV will result in no change.

The IRR model (which is also referred to as the actuarial, the marginal efficiency of capital, and the yield model) uses the same net cashflows as the NPV model but expresses the end-result as a percentage yield. Provided this percentage yield is greater than the organisation’s cost of finance/hurdle rate, then the project is said to be acceptable from a financial point of view. The IRR for a project is therefore the discount rate, which reduces the stream of net returns from the project to a present value of zero.

There are, however, two main problems with the IRR, (i) the possibility of arriving at multiple rates, and (ii) concerns over the reinvestment
Calculating the MIRR from the NPV

Both these problems have been overcome by modifying the IRR model to arrive at what is generally known as an MIRR. Under the conventional IRR model, a rate of return is calculated which equates the discounted net cash outflows with the net cash inflows, a situation where the NPV is equal to zero. The most common form of MIRR, however, compounds the net cash inflows to a single figure at the end of a project’s economic life. Then, using the cost of the project as a base figure, calculate the modified return for a project using the following formula, \[ \left( \frac{\text{compounded cash inflows}}{\text{cost of project}} \right)^{1/n} - 1 \] \times 100, where ‘n’ is the length of the project. This gives the compound interest rate which when applied to the base cost of the project produces the compounded net cash inflow figure at the end of the life of the project. As the ‘inflow’ in the final year has been arrived at by assuming a reinvestment rate equal to the cost of capital and not at the project’s IRR, then the MIRR will usually (i.e. where the IRR is greater than the costs of capital) produce a figure that will be lower than the IRR. The figure produced, however, is arguably more ‘realistic’ and therefore more meaningful than the conventional IRR. The MIRR will, in all cases, provide a compatible accept/reject decision with the NPV rule, where ‘accept’ is when the \[ \text{NPV} > 0 \] and the \[ \text{MIRR} > \text{Cost of Capital} \].

Until recently, both the NPV and MIRR, although using the same cash-flows, have been arrived at independently. What this appendix shows is that the MIRR can be calculated from the NPV through a project’s NPVP. The NPVP extends the NPV by incorporating the discounted payback (DPB), the discounted payback index (DPBI), and the marginal growth rate (MGR), into a financial profile of an investment opportunity. The NPVP shows a natural progression from NPV to MGR from which the MIRR can be calculated.

The net present value profile

\[ \text{NPV} \Rightarrow \text{DPB} \Rightarrow \text{DPBI} \Rightarrow \text{MGR} \Rightarrow \text{MIRR} \]

Calculating the MIRR from the NPVP

In our simplified example (Table A2.1), we look at a project which has a capital cost of £175,000 and an estimated useful life of ten years. The scrap value of the equipment, estimated at £7,500, is taken into account in the final year of the project by increasing the net cash inflow for that year. The company’s cost of capital is 8%. For simplicity, the figures in our example ignore taxation and inflation, and the scrap value is included within the cash inflow figure for year 10. From this data it can
The Application of the FAP Model to ICT Projects

Table A2.1  Calculating the MIRR from the NPV

<table>
<thead>
<tr>
<th>Year</th>
<th>Net cash inflow (£)</th>
<th>Discount factor 8%</th>
<th>PV of net cash inflows (£)</th>
<th>Cumulative PVs (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>52,000</td>
<td>0.926</td>
<td>48,152</td>
<td>48,152</td>
</tr>
<tr>
<td>2</td>
<td>57,000</td>
<td>0.857</td>
<td>48,849</td>
<td>97,001</td>
</tr>
<tr>
<td>3</td>
<td>60,000</td>
<td>0.794</td>
<td>47,640</td>
<td>144,641</td>
</tr>
<tr>
<td>4</td>
<td>60,000</td>
<td>0.735</td>
<td>44,100</td>
<td>188,741</td>
</tr>
<tr>
<td>5</td>
<td>60,000</td>
<td>0.681</td>
<td>40,860</td>
<td>229,601</td>
</tr>
<tr>
<td>6</td>
<td>60,000</td>
<td>0.630</td>
<td>37,800</td>
<td>267,401</td>
</tr>
<tr>
<td>7</td>
<td>60,000</td>
<td>0.583</td>
<td>34,980</td>
<td>302,381</td>
</tr>
<tr>
<td>8</td>
<td>60,000</td>
<td>0.540</td>
<td>32,400</td>
<td>334,781</td>
</tr>
<tr>
<td>9</td>
<td>60,000</td>
<td>0.500</td>
<td>30,000</td>
<td>364,781</td>
</tr>
<tr>
<td>10</td>
<td>27,500</td>
<td>0.463</td>
<td>12,733</td>
<td>377,514</td>
</tr>
<tr>
<td>Totals</td>
<td>556,500</td>
<td></td>
<td>377,514</td>
<td></td>
</tr>
</tbody>
</table>

Calculations:
NPV: (Present value of net cash inflows – capital cost of project) = (£377,514 – £175,000) = £202,514.
DPB = [3 + (30359/44100)] = 3.69 years.
DPBI = (Present value of net cash inflows/capital cost of project) = (£377,514/£175,000) = 2.1572.
MGR = [(DPBI)^{1/n} – 1] × 100 = [(2.1572)^{1/10} – 1] × 100 = 7.99%.
MIRR = [(1 + 0.0799) × (1 + 0.08) = (1.0799 × 1.08) = 1.1663, MIRR = (1.1663 – 1) × 100] = 16.63%.

be seen that, with a capital cost of £175,000 and a total discounted net cash inflow of £377,514, the project has a positive NPV of £202,514. This is the gain in present value terms that the company can expect to achieve if it accepts the project – it is the discounted return in excess of the capital cost of the project.

The DPB calculates what may be described as the break-even point at which the discounted returns from a project are equal to the capital cost of the project. It shows the time that it will take to recover the initial cost of the project after taking into account the cost of capital. It is superior to the conventional payback approach, as it takes into account the future value of money. As the cashflows from a project are discounted, the DPB will always show a longer payback period than the standard payback model and may therefore be regarded as more conservative.

In our example, the DPB is calculated as follows: The cumulative discounted net cash inflow at the end of year 3 is £144,641, which shows
a payback period greater than three years. The company then needs
to achieve a further discounted net cash inflow of £30,359 (£175,000–
£144,641) to arrive at the actual discounted payback period. As the
discounted net cash inflow during year 4 is £44,100, which is greater
than that required to break-even, the additional payback period is
30,359/44,100 (0.69), giving a total payback period of three years plus
0.69 = 3.69 years (this assumes a linear increase in net cash inflows dur-
ing the year, if this is not the case and a more accurate figure is required,
then actual monthly net cashflows may be used). The company will
therefore be placed back in its original financial position in just over
three and a half years, having recovered the whole of the cost and
financing of the project in that time.

A natural progression from the DPB is the calculation of the DPBI,
which is similar to the profitability index. The DPBI is calculated by
dividing a project's initial capital cost into its accumulated discounted
net cash inflows. This index shows how many times the initial cost of an
investment will be recovered during a project's useful life and is there-
fore a further measure of a project's profitability. The higher the index,
the more profitable will be the project in relation to its capital cost.
A DPBI of 1.0 will show that the project will only recover the capital
cost of an investment once, while a DPBI of 3.0 shows that the initial
cost will be recovered three times.

A weakness of the payback model (whether conventional or dis-
counted) is the fact that it ignores the cashflows after the payback
period. By highlighting the DPBI, this weakness is eradicated because
the total cashflows from a project are now taken into account. In our
example, the DPBI can be calculated by dividing the capital cost of the
project into the present value of net cash inflows (£377,514/£175,000),
which gives a figure of 2.1572. This means that the project recovers just
over twice its original cost.

The final stage in the progression of the NPVP is the calculation of the
MGR which is reached through the DPBI, where \( \text{MGR} = \left[ \frac{(\text{DPBI})^1}{n} - 1 \right] \times 100 \). The MGR is the marginal return on a project after discounting the
cash inflows at the cost of capital and can be viewed as a ‘net’ variant
of the MIRR. To validate the meaning of the MGR, it can be seen that
applying a compound interest rate equal to the MGR to the initial cost
of a project will produce, in the lifespan of that project, a value equal
to the present value of the project’s net cash inflows. This is therefore
the growth rate that, when applied to the capital cost of the project, will
produce the NPV of the project. Unlike the DPBI, the MGR reflects the
economic life of a project. Although the DPBI of two projects may be
Table A2.2  Traditional method of calculating the MIRR

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital inflow (£)</th>
<th>Reinvestment rate 8%</th>
<th>Value (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>52,000</td>
<td>1.999</td>
<td>103,948</td>
</tr>
<tr>
<td>2</td>
<td>57,000</td>
<td>1.851</td>
<td>105,507</td>
</tr>
<tr>
<td>3</td>
<td>60,000</td>
<td>1.714</td>
<td>102,840</td>
</tr>
<tr>
<td>4</td>
<td>60,000</td>
<td>1.587</td>
<td>95,220</td>
</tr>
<tr>
<td>5</td>
<td>60,000</td>
<td>1.469</td>
<td>88,140</td>
</tr>
<tr>
<td>6</td>
<td>60,000</td>
<td>1.361</td>
<td>81,660</td>
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<tr>
<td>7</td>
<td>60,000</td>
<td>1.260</td>
<td>75,600</td>
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<td>8</td>
<td>60,000</td>
<td>1.166</td>
<td>69,960</td>
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<td>9</td>
<td>60,000</td>
<td>1.080</td>
<td>64,800</td>
</tr>
<tr>
<td>10</td>
<td>27,500</td>
<td>1.000</td>
<td>27,500</td>
</tr>
<tr>
<td>Totals</td>
<td>556,500</td>
<td></td>
<td>815,175</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Net cash inflows from the project</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>52,000</td>
</tr>
<tr>
<td>2</td>
<td>57,000</td>
</tr>
<tr>
<td>3</td>
<td>60,000</td>
</tr>
<tr>
<td>4</td>
<td>60,000</td>
</tr>
<tr>
<td>5</td>
<td>60,000</td>
</tr>
<tr>
<td>6</td>
<td>60,000</td>
</tr>
<tr>
<td>7</td>
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<td>9</td>
<td>60,000</td>
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<td>10</td>
<td>27,500</td>
</tr>
<tr>
<td>Totals</td>
<td>556,500</td>
</tr>
</tbody>
</table>

The MIRR of the project (based on a cash outflow of £175,000 in year 0 and a single cash inflow in year 10 of £815,175 = 16.63% \([(\text{compounded cash inflows/cost of project})^{1/n} - 1] \times 100 = [(£815,175/£175,000)^{1/10} - 1] \times 100 = 16.63\%).

identical, if these projects have different economic lives, the MGR will be lower for the longer life project. In our example, the MGR is 7.99% \([(\text{DPBI})^{1/n} - 1] \times 100 = [(2.1572)^{1/10} - 1] \times 100\) and is a measure of the project’s rate of net return.

The mathematical ‘relationship’ between the MGR and the most commonly used MIRR is \((1 + \text{MIRR}) = (1 + \text{MGR}) \times (1 + \text{cost of capital}).\) The MIRR for the above example is 16.63% \([(1 + 0.0799) \times (1 + 0.08) = (1.0799 \times 1.08) = 1.1663. \text{MIRR} = (1.1663 - 1) \times 100 = 16.63\%].\) Table A2.2 shows the traditional method of calculating the MIRR of the project and confirms the figure calculated using the NPV approach.

Through adopting the NPVP approach, we have demonstrated a way of calculating the MIRR from the NPV of a project, which should in future become the standard way of determining a project’s MIRR.
Notes

1 Introduction


5. It is generally accepted that sophisticated financial appraisal techniques are those that consider the discounted net cashflows from a project and make adjustments for, or take into account, project risk. Unsophisticated (naive) models are generally taken as those techniques that do not consider DCF or incorporate risk in any systematic manner, that is, PB and ARR.


9. See, for example, Woods, M., Pokorny M., Lintrntr V., and Blinkhorn, M., 1985, Appraising investment in new technology. Management Accounting, 63 (9), 42–43.


11. For a detailed meaning of how we define ‘complex’, we refer the reader to the next chapter of this book.

13. See, for example, Keef, S., and Olowo-Okere, E., 1998, Modified internal rate of return: A pitfall to avoid at any cost! *Management Accounting*, 76 (1), 50–51.

14. The uncertainty of estimating future cashflows increases with time; the longer the project’s life, the greater the difficulty in estimating cashflows in the later years. This uncertainty in itself creates a risk that the ultimate benefits expected from a project may not materialise.


19. See, for example, Kaplan, R. S., 1986, Must CIM be justified by faith alone? *Harvard Business Review*, 64 (2), March/April, 87–95.


24. EVA™ is a trademark of the Stern Stewart Corporation.


29. The Delphi technique (from ‘Project DELPHI’, named from the Oracle at Delphi in Ancient Greece) was developed by Olaf Helmer, Nicholas Rescher, and colleagues at the RAND Corporation, Santa Monica, California, USA, in the early 1950s to elicit opinions from a group of experts regarding urgent defence problems (Helmer, O., and Rescher, N., 1959, On the epistemology of the inexact sciences. *Management Science*, 6 (1), 25–52).


2 The Perception that ICT Projects Are Different


3 The Appraisal of ICT and Non-ICT Projects: A Study of Practices of Large UK Organisations


11. This chapter is taken from the following publication, Lefley, F., 2013, The appraisal of ICT and non-ICT capital projects: A study of the current


28. See, for example, Lefley, F., 2008, Research in applying the financial appraisal profile FAP model to an information communication technology project.


4 Evaluating ICT Project Risk: An Exploratory Study of UK and Czech Republic Practices


36. Lintner, 1965, p. 591, however, argues that, assuming the investor is a risk averter, the curve may be concave upwards indicating that, as the risk of their investment position increases, even larger increments of expected return are required to make the investor feel ‘as well off’.


5 The Development of the FAP Model


11. We use the normative term ‘protocol’ to highlight the FAP model’s emphasis on what ought to be done rather than the descriptive terms of either ‘process’ or ‘procedure’.


6 The FAP Model – Basic Data

Notes


7. Support for interpreting the NPV as an ‘economic return’ is found in the modern financial literature, see, for example, Grinblatt, M., and Titman, S., 1998, *Financial Markets and Corporate Strategy*. (Boston: Irwin/McGraw-Hill), where they refer to the ‘economic value added’ version of the NPV, as a measure of a company’s true economic profitability.

8. The term ‘residual value’ is given to the terminal value of a capital investment and may be calculated using a number of methods of which the most common are: (a) the Price/Earnings ratio which is used to calculate the best estimate of the investments market value, (b) the Perpetuity method which estimates the residual value as being the PV of an ongoing stream of future cashflows, (c) the book value of the investment, and (d) the liquidation value of the investment.

7 The FAP Model – The Net Present Value Profile (NPVP)


3. The most common form of MIRR compounds the net cash inflows to a single figure at the end of the project’s economic life and then, using a base figure for the cost of the project, calculates the modified return from that project, when, using interest tables, the interest rate is found which when applied to the base cost of the project produces the compounded net cash inflow figure at the end of the life of the project.


11. The mathematical ‘relationship’ between the MGR and the MIRR is 
\[ (1 + \text{MIRR}) = (1 + \text{MGR}) \times (1 + \text{cost of capital}). \] See also Lefley, F., 2004, Clear and present value. Accounting Technician, June.


8 The FAP Model – The Project Risk Profile (PRP)


3. By negative outcome, we mean an outcome that is less financially or strategically advantageous to the firm compared with the expected position if the project were not to proceed.

4. In theory, the importance of risk is the product of its impact multiplied by its probability of occurrence (\( R = \text{I} \times \text{P} \)). This therefore assumes that managers will treat, as having the same value (importance) and have no preference for either, a specific risk with an impact of 60 (on a scale of 0–100) and a probability of 10%, and a risk with an impact of 10 and a probability of 60% (both having a value of 6.0). Tests, however, from a small sample of managers, suggested that they treated as ‘equal’ a risk with an impact of 55 and a probability of 10% (5.5), and an impact of 10 with a probability of 60% (6.0). Managers were clearly placing a greater level of significance to higher levels of risk impact, by subconsciously applying a disutility factor to the impact values – in this example the disutility factor is 1.0909, so that 
\[ 55 \times 0.1 \times 1.0909 = 6.0, \] which equates to \( 10 \times 0.6 = 6.0 \). So, by applying a disutility factor to the perceived risk impact value, a DIV is achieved. It is argued that the disutility factor will increase exponentially from 1 to (in this example) 1.0909.


6. Debate is the spontaneous emergent task-focused discussion of differing perspectives and approaches to the task in hand and includes the questioning or challenging of assumptions, reasoning, criteria, or sources of information, disagreement with direct and open presentation of rival recommendations.


11. One may also assume that with a reasonably large team and a number of ‘iterations’ within the ‘quasi-Delphi approach’ the idiosyncratic beliefs are likely to be diversified away leaving a core of rational beliefs as the dominating influence in the group judgement.


9 The FAP Model – The Strategic Index (SI)


10 Summary Comments on the FAP Model


11 Applying the FAP Model to an ICT Project within a Professional Association


18. This chapter is taken from the following publication, Lefley, F., 2008, Research in applying the financial appraisal profile (FAP) model to an information communication technology project within a professional association. *International Journal of Managing Projects in Business*, 1 (2), 233–259.

19. Members, from both the management team and corporate management, directors/council members, were asked to indicate, on a scale of 0 to 10, whether they perceived themselves to be risk-averse or risk-takers in a business context, with 0 indicating that they were prepared to take no risks at all and 10 indicating that they perceived themselves to be very high risk-takers. They were then asked to multiply this figure by a factor of 10 and told that this would now represent the percentage level of a specific risk impact on a capital project. They were then asked to indicate the maximum level of risk probability, in relation to this level of impact, which they would be prepared to accept as an individual and specific to their own area of responsibility and risk control. The data obtained were respectively – impact/probability – for five members of the management team, 70/10, 20/90, 65/10, 80/10, 75/10 and for six directors/council members, 80/10, 75/15, 30/50, 55/5, 70/15, 50/20. It is interesting to note (assuming the figures were entered correctly, which, as one will appreciate, makes no difference to the calculation of the mean value) that in both sets of figures there is one individual who shows a low impact figure, but a high probability value, which results in high-RVs, where RV = I × P. So, on the one hand, they perceive themselves to be risk-averse, while, on the other hand, they show themselves to be high-risk-takers. The arithmetic mean for the management team was 9.4, while the arithmetic mean for the directors/council members was 9.58. It was therefore agreed that the CRT should be 9.5.

20. In theory, the importance of a particular project-specific risk is the product of its perceived impact multiplied by its probability of occurrence (R = I × P). This therefore assumes that managers will treat, as having the same value (importance) and have no preference for either, a specific risk with an impact of 60 (on a scale of 0 to 100) and a probability of 10%, and a risk with an
impact of 10 and a probability of 60% (both having a value of 6.0). Limited tests, however, suggest that managers treat as ‘equal’ a risk with an impact of 55 and a probability of 10% (5.5), and an impact of 10 with a probability of 60% (6.0). Managers were clearly placing a greater level of significance to higher levels of risk impact, by subconsciously applying a disutility factor to the impact values – in this example, the disutility factor is 1.0909 so that 55 × 0.1 × 1.0909 = 6.0 which equates to 10 × 0.6 (= 6.0). So, by applying a disutility factor to the perceived risk impact value, a DIV is achieved. It is argued that, in this instance, the disutility factor will increase exponentially from 1 to 1.0909 for impact values of between 1 and 55. The formula for arriving at a disutility factor is 
\[ c = (b - 1)/[\ln(a/b)]; \quad y = e^{[(x-1)/c]} \]
If a = 60 and b = 55, then a/b = 1.0909; c = (55 – 1)/(1n 1.0909) = 620.6679. So that if x = 55, then \[ y = e^{[(55-1)/620.6679]} = 1.0909. \] If, for example, x = 40, then \[ y = e^{[(40-1)/620.6679]} = 1.0649. \]

Appendix 1: The Accounting Rate of Return

1. This appendix is based on an earlier published paper by the author: Lefley, F., 1998, Accounting rate of return: Back to basics. Management Accounting (UK), 76 (3), 52–53.

2. Note:
   *Depreciation based on straight line method*
   - Year 1, £9,487; Year 2, £9,487; Year 3, £9,487; Year 4, £9,487; Year 5, £9,487. [Total depreciation £47,435].

   *Accumulated depreciation*
   - End of Year 1, £9,487; Year 2, £18,974; Year 3, £28,461; Year 4, £37,948; Year 5, £47,435.

3. Note:
   *Depreciation based on 40% reducing balance*
   - Year 1, £20,574; Year 2, £12,344; Year 3, £7,407; Year 4, £4,444; Year 5, £2,666. [Total depreciation £47,435].

   *Accumulated depreciation*
   - End of Year 1, £20,574; Year 2, £32,918; Year 3, £40,325; Year 4, £44,769; Year 5, £47,435.

*Net income*
- Year 1, £574 (loss); Year 2, £12,656; Year 3, £12,593; Year 4, £10,556; Year 5, £4,334. [Total net income £39,565].

*ROI Investment*
- Beginning of Year 1, £51,435; Year 2, £30,861; Year 3, £18,517; Year 4, £11,110; Year 5, £6,666.

*ROCE Investment*
- Beginning of Year 1, £56,000; Year 2, £35,426; Year 3, £23,082; Year 4, £15,675; Year 5, £11,231. [It is assumed that the working capital is required at the beginning of the first year].

*ROI*
- Year 1, 1.12% loss; Year 2, 41.01%; Year 3, 68.01%; Year 4, 95.01%; Year 5, 65.02%.

*ROCE*
- Year 1, 1.03% loss; Year 2, 35.73%; Year 3, 54.56%; Year 4, 67.34%; Year 5, 38.59%.

Appendix 2: Calculating the Modified Internal Rate of Return from the Net Present Value


Index

abandonment option, see option theory
abandonment value, 88, 89, 102, 104, 105, 111, 112, 121, 144, 158, 160, 174
ABC, see activity based costing
accounting rate of return, 1, 3, 4, 5, 6, 7, 29, 53, 65, 101, 176
calculation of, 182–7
deficiencies, 182
initial versus average investment, 183–4
reasons for use, 183
‘Accounting technician’, 101
activity based costing, 139
advanced manufacturing technology, 28, 72, 142, 152
AMT, see advanced manufacturing technology
ARR, see accounting rate of return
availability heuristics, 18, 125
balanced scorecard, 13, 14, 15
Ballantine and Stray, 36, 38
Bannister, 154
Bayes’ Theorem, 114
Bengtsson, 102
Bentham, 76
Berstein, 70
beta, 10
Booth, 101
capital asset pricing model, 10, 11, 14, 31, 32, 57, 58, 66, 68, 70, 71, 75, 77, 79, 96
capital cost of project, 6, 8, 45–6, 86, 88, 89, 91, 92–6, 104, 106, 107, 108, 110, 157, 180, 183, 185, 188
capital investment decision making, 2, 8
CAPM, see capital asset pricing model
cash generation, 85, 87
certainty equivalent value, 9, 31, 70, 75
approach, 76
CE-v, see certainty equivalent value
coefficient of variation, 118, 123, 168
cognitive availability, 127
complexity, 22, 45, 52, 73, 82, 84
discussion on, 85
and the FAP model, 86
and new technology, 149
conceptional reasoning, 84–6
consensus outcome, 19–20, 142
discussion on, 19
controlled conflict, 20, 120, 165, 178, 179
corporate ranking, 128, 138, 170, 173
corporate risk threshold, 115, 122, 131, 144, 145, 157, 169, 212
meaning of, 116
cost/benefit analysis, 86, 87, 89
cost of capital, 1, 5, 7, 12, 14, 54, 75, 91, 94, 102, 104, 109, 115, 159, 174, 189
and the FAP model, 99
meaning of, 96
see also opportunity cost of capital
Cotton, 38
CR, see corporate ranking
CRT, see corporate risk threshold
DCF, see discounted cash flow
decision-making, 2, 8, 23, 34, 35, 144
conflict, 20, 50, 120, 135, 165, 171, 178, 179
consensus outcome, 142
and the FAP model, 149–51
financial, 61, 92
group discussion, 15, 17, 131, 135
groupthink, 177
investment, 85, 128
judgmental approach, 36
process, 11, 64, 76, 82, 135
strategic, 13, 146
decision trees, 31, 32, 57, 70, 71
explanation of, 73
practical limitations, 73
De la Cruz, 70, 76
Del Cano, 70, 76
Delphi model, 119, 125, 133, 135,
146, 154, 158, 161–4, 166, 170,
177
classical, 17
decision, 17
explanation of, 16–18
policy, 17
De Moivre, 70
discounted cash flow, 1, 14, 68, 76, 86,
90, 107, 157
models, 4, 8, 55, 65, 75, 88, 176, 185
discounted payback, 29, 52, 189, 191
advantage over the PB, 108–10
discounted payback index, 91, 189
discount rate, 6, 7, 31, 52, 80, 88, 93,
99, 104, 137, 188
determination of, 55, 80, 157
influences on, 54
risk adjusted, 9, 58, 68, 69, 75, 80
risk free, 9, 76
unadjusted, 105
used in valuation of a company, 10
see also cost of capital; opportunity
cost of capital
dissensus, 135, 178
disutility impact value, 116, 117, 122,
124, 146, 157
DIV, see disutility impact factor
DPB, see discounted payback
DPBI, see discounted payback index
economic value, 13, 14, 85, 92
economic value added, 13, 14, 15
embeddedness, 85, 86
expected utility, 76
FAP model, 90, 101, 141
advantages of, 3, 147–8
aid to decision-making, 149–51
case study, 152–81
constituent parts of, 91
development of, 82–91
discussion on, 4–8
and ICT projects, 52–4
justification of, 1, 2
positioning of, 86–90
protocol, 90, 91, 100, 114, 116, 121,
132, 136, 142, 144, 146, 148,
149, 154, 157–8
summary comments, 144–51
Feldman, 153
financial theory, 8, 9, 31, 70, 153
interface with risk, 9–11
financial uncertainty, 86
generalised adjusted present value, 6
groupthink, 19, 20, 127, 134, 147,
154, 155, 158, 177, 179, 181
growth option, 22, 74, 89, 90, 142
Habermas, 155
Hambrick, 142
Heemstra, 41, 153
Hertz, 127
heuristics, 18, 125, 147, 154
ICT, see information communication
technology
information communication
technology, 1, 2, 3, 20
application of the FAP model, 174
appraisal, 34–67
appraisal problems, 20, 63
appraisal teams, 46–8
assessment of, 28, 33
case study, 152–81
classification of projects, 40–1
departmental influence, 48–50
financial models used, 30, 34,
53–6, 62
formal appraisal, 28–9, 41–4, 51–2
importance of investing, 34–5
perceived differences, 21–33
post audit, 44–5
project champion, 50–1
project risk, 32, 56–9, 68–81
internal rate of return, 1, 4, 5, 7, 30,
52, 53, 54, 66, 87, 101, 108, 152,
176, 188, 189
calculation of, 6, 7
the failings of, 6, 21, 188
financial indicator, 188
internal rate of return – continued
hurdle rate, 8, 31, 32, 56, 57, 58, 71, 77, 88
importance of, 54
management preference, 7, 53, 101, 188
as a measure of performance, 29
IRR, see internal rate of return
IT score, 22, 154, 158, 159, 174, 175
JIT, see just in time
judgmental heuristics, 18, 125–6
just in time, 118
Kahneman, 125, 126
Keef, 101
Kotler, 18
Kusters, 153
Likert scale, 25, 37, 69
support for, 26
manipulation (of investment decision), 14, 17, 181, 183
marginal growth rate, 91, 102, 103, 104–8, 110, 144, 145, 159, 160, 174, 189, 190, 191, 192
MGR, see marginal growth rate
MIRR, see modified internal rate of return
modern portfolio theory, 77
modified internal rate of return, 7, 29, 30, 52, 53, 101, 106
advantage, 6
calculating, 108, 192
importance, 54, 66
linkage to NPV, 188–92
Monte Carlo simulation, 86
Multi-attribute model, 84
FAP as a, 90, 91, 144, 154
net present value, 1, 4, 7, 30, 53, 54, 66, 73, 76, 85, 87, 90, 92, 100, 104, 152, 188
academic preference, 3, 5, 29, 101
calculation of, 105, 157, 160, 190
the definitive technique, 1
determination of, 154
discount rate used, 7, 8, 10, 56, 58, 75, 92
faults/deficiencies, 6, 21, 110–11, 112, 152
lack of management support, 3, 101, 108, 176
preference, 52, 53
seen in a different light, 102, 104
shareholder value, 100
net present value profile, 83, 91, 100–12, 144, 188, 189
advantage of, 110–11, 121, 144, 189
calculation of, 104–8, 159–60
discount rate used, 93, 96, 99, 157
NPV, see net present value
NPVP, see net present value profile
Olowo-Okere, 101
opportunity cost of capital, 1, 54, 55, 85, 92, 96, 98–9
option theory, 22, 31, 32, 57, 66, 70, 71, 73–4, 79
abandonment, 22, 74, 87–8, 102, 104, 105, 147, 159, 160, 175
deferment, 22, 87, 88, 90, 147
growth, 22, 74, 87, 89, 90, 142, 147
reduction, 87, 89, 147
see also real options
payback, 1, 3, 4, 6, 8, 31, 32, 57, 58, 66, 68, 74, 78, 80, 103, 174, 190
advantage of the DPB over, 108–10
importance, 30, 53, 54, 56, 57, 65
liquidity, 7, 29
popularity, 5, 9, 30, 52, 53, 57, 61, 71
short-termism, 60–1
time risk, 7, 8, 31, 71–2, 75, 88
weakness of, 5–6, 21–2, 106, 191
see also discounted payback
PB, see payback
perceived environmental uncertainty, 91, 132
positivist approach, 34, 152, 153
post audit, 36, 37, 38, 44–5, 65, 179, 180
post completion audit, see post audit
pragmatic, 2, 9, 12, 20, 30, 31, 61, 70, 72, 74, 83, 84, 86, 126, 148, 153
present value index, 6
primary profile model, 12, 142
probability analysis, 8, 31, 32, 57, 66, 70, 73, 75, 79
project appraisal, 24, 30, 33, 50, 52, 55–6, 66, 69
departmental influence, 37, 48–50, 67
formal/informal assessment, 37, 41, 51–2, 66, 67, 70
other factors considered, 59–60, 67
project capital cost, 6, 8, 45–6, 86, 88, 89, 91, 92–6, 104, 106–8, 110, 157, 180, 183, 185, 188
project champion, 36, 37, 50–1, 90, 132, 155, 170, 176, 177, 179, 181
excessive influence, 65, 179, 181
project evaluation matrix, 2, 86, 87, 88, 89
project life, estimation, 91, 99
project risk profile, 91, 113–27
calculation of, 121–5
and CRT, 116–17
protocol, 118–21
project specific risk, 3, 10, 24, 25, 32, 37, 51, 52, 55, 58, 62, 67, 68, 72, 73, 75, 80, 81, 82, 87, 88, 91, 98, 99, 101, 102, 104, 105, 107, 113, 114, 153, 159, 161, 173, 175, 181
project strategic score value(s), 128, 133, 134, 142, 177
calculation of, 141, 171–3
PRP, see project risk profile
PSSV, see project strategic score value
quasi-delphi approach, 119, 120, 125, 126, 127, 133, 134, 146, 154, 158, 163, 166, 170, 177, 178
RAI, see risk area index
real options, 73–4, 84, 87, 88, 90
Remenyi, 154
research path (in developing the FAP model), 2, 83–6
research – pragmatic approach, 13, 84
return on capital employed, 182
return on investment, 30, 53, 54, 62, 65, 182, 184, 185, 186, 187
risk analysis, 56–9
risk appraisal models, 8–9, 21
risk area index, 115, 116, 118, 121, 122, 124, 125, 145, 161, 170, 174
estimating, 116
risk areas, 117–18, 123, 124, 125, 126, 146, 170
see also risk, area of responsibility
risk, areas of responsibility, 116, 119, 123, 125, 161, 167–8, 170
risk, interface with finance, 9–11
risk, negative aspect of, 69
risk profile, 23, 75, 96, 116, 118, 121, 122, 125, 126, 127, 146, 160, 161, 169, 170
see also project risk value
risk, uncertainty, 69–70
risk value, 114, 115, 119, 121, 125, 126, 145, 161, 169, 170, 177, 179
calculation of, 118, 121, 122, 124, 169
ROCE, see return on capital employed
ROI, see return on investment
RV, see risk value
Sarkis, 72
Schinski, 38
score models, 5, 11, 86, 87, 89, 90
sensitivity analysis, 8, 9, 22, 31, 32, 56, 57, 66, 70, 71, 72, 73, 74, 79, 86, 87
short-termism, 4, 39, 60, 61, 62, 69, 80, 185
SI, see strategic index
Simons, 135, 178
strategic index, 91, 128–43
calculation/determination of, 136–41, 165–73, 174
protocol, 129–36
worked example, 136
strategic models, 2, 11–12, 89, 142
strategic score models, 86, 87, 89
taxation, 8, 55, 95
impact of, 94–5
team approach, 2, 3, 13, 19, 48, 135, 141, 149, 177, 178
conflict, 135
importance of, 48
team facilitator, 17, 90, 91, 119, 120, 121, 125, 127, 132, 134, 135, 136, 138, 156, 161, 163, 165, 166, 170, 176, 178, 181
transitivity, laws of, 131
transparency, 181
Tversky, 125, 126
utility theory, 22, 76
WACC, see weighted average cost of capital
Ward, 38, 44
weighted average cost of capital, 75, 96, 97, 98
Whitley, 153
working capital, 184, 185, 186, 187
treatment of, 95–6