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The length of time required to recover the initial investment in a capital asset is known as the:

Learning objective To evaluate investments using the return method. Question: Although the methods of net present value (NPV) and internal rate of return (IRR) are the most used approaches to evaluate investments, some managers also use the return method. What is the return method and how does it help managers make decisions related to long-term investments? Answer: The return method evaluates how long it will take to pay or recover the initial investment. The return period, usually declared in years, is the time required to generate sufficient cash receipts for an investment to cover cash outflows for the investment. Managers who are concerned about cash flow want to know how long it will take to recover the initial investment. The revenue method provides this information. Managers may also require a return period equal to or less than some specified period of time. For example, Julie Jackson, the owner of Jackson's Quality Copies, may require a return period of no more than five years, regardless of NPV or IRR. Note that the method of revenue has two significant weaknesses. First, you don't consider the value of money time. Secondly, it considers only cash receipts until the cash outflows of the investment are recovered; cash entries after the return period are not part of the analysis. Both weaknesses require managers to use caution when applying the return method. Question: What is the return period for the proposed purchase of a copier on Jackson's Quality Copies? Answer: The return period is five years. That's how we calculate. Figure 8.6 Summary of Cash Flows for Copy Machine Investment by Jackson's Quality Copies repeats the cash flow estimates for Julie Jackson's planned purchase of a copier for Jackson's Quality Copies, the example presented at the beginning of the chapter. Figure 8.6 Summary of Cash Flows for Copy Machine Investment by Jackson's Quality Copies The return method answers the question how long it will take to recover my initial \$50,000 investment? With annual cash receipts of \$10,000 from year 1, the return period for this investment is 5 years (= \$50,000 initial investment ÷ \$10,000 annual cash receipts). This calculation is relatively simple when an investment is made at the beginning, and the annual cash receipts are identical. However, some investments require cash outflows at different points over the lifetime of the asset, and cash receipts can vary from one year to the next. Table 8.1 Calculating the Return Period for Jackson Quality Copies provides a format to help calculate the return period of these investments more Note that the revision issue at the end of this segment provides an example of how to calculate the return period for the nearest month when irregular cash flows are expected. Table 8.1 Calculating the Period for Investment in Quality Copies of Jackson (Cash Out) Unrecovered Cash Flow Investment Balance 0 \$(50,000) – \$(50,000)per Year 1 – \$10,000 (40,000)b Year 2 – 10,000 (30,000)c Year 3 – 10,000 (20,000) Year 4 – 10,000 10,000 (10,000) Year 5 – 10,000 0 Year 6 – 10,000 0 Year 7 – 15,000 0 to \$(50,000) = \$(50,000) initial investment.b \$(40,000) = unrecovered investment balance of \$(50,000) + \$10,000 year 1 cash receipt. c \$(30,000) = \$(40,000) unrecovered investment balance at the end of the year 1 + \$10,000 year 2 cash receipt. Question: Why is it a problem to ignore the value of money time when calculating the return period? Answer: Suppose you have 2 investments of \$10,000 to choose from. The first investment generates cash inflows of \$8,000 in year 1, \$2,000 in year 2, and \$1,000 in year 3. The second investment generates cash inflows of \$2,000 in year 1, \$8,000 in year 2, and \$1,000 in year 3. The two investments are summarized here: Both investments have a two-year return period. Does this mean that both investments are of equal value? Not because the first investment generates a lot more money in the first year than the second investment. In fact, it would be preferable to calculate the IRR to compare these two investments. The IRR for the first investment is 6%, and the IRR for the second investment is 5%. Question: Why is it a problem to ignore cash flows after the return period? Answer: Suppose \$50,000 can be invested in 2 separate investments with the following cash flows: The first investment has a two-year return period, and the second investment has a three-year return period. If the company requires a return period of two years or less, the first investment is preferable. However, the first investment generates only \$3,000 in cash after its return period, while the second investment generates \$35,000 after its return period. The return method ignores these two values, although the second investment generates significant cash inflows after year 3. Again, it would be preferable to calculate the IRR to compare these two investments. The IRR for the first investment is 4%, and the IRR for the second investment is 18%. Although the return method is useful in certain situations where companies are concerned about recovering investments as quickly as possible (e.g. companies on the verge of bankruptcy), it is not a measure of profitability. The NPV and IRR methods compare the profitability of each investment considering the value of money time for all investment-related cash flows. In the example of Jackson's Quality Copies presented throughout this chapter, the company is considering buying a new copier for \$50,000. A it's been going on since Mike Haley, an accountant, discussed this investment with Julie Jackson, president and owner. See Figure 8.2 NPV NPV for Copy Machine Investment by Jackson's Quality Copies, Figure 8.4 Alternative NPV Calculation for Jackson's Quality Copies and Figure 8.5 Finding the IRR for Jackson's Quality Copies, and Table 8.1 Calculating the Return Period for Jackson Quality Copies as you learn what Mike's findings are. Capital Budget at Fortune 1000 Companies Studies completed over the past 40 years have indicated that managers prefer to use IRR and payback methods over NPV when evaluating long-term investments. However, a recent survey of Fortune 1000 chief financial officers indicates that NPV is now the most preferred method. According to this research, the percentage of companies that always or often use each method is as follows: This research also shows that companies with capital budgets greater than \$500,000,000 are more likely to use these methods than companies with smaller capital budgets. This is probably because larger companies have more specialized personnel in their financial and accounting departments, allowing them to use more sophisticated approaches in evaluating long-term investments. Source: Patricia A. Ryan and Glenn P. Ryan, Capital Budgeting Practices of the Fortune 1000: How Have Changed? Business and Management Magazine 8, no. 4 (2002). Key Takeaway The return method evaluates how long it will take to pay or recover the initial investment. The return period, usually declared in years, is the time required to generate sufficient cash receipts for an investment to cover cash flow for the investment. While this method is useful for cash flow-related managers, the main weaknesses of this method are that it ignores the value of money time, and ignores cash flows after the return period. This review issue is a continuation of Note 8.22 Review Problem 8.3 and Note 8.26 Review Problem 8.4 and uses the same information. The management of Chip Manufacturing, Inc., would like to buy a specialized production machine for \$700,000. The machine is expected to have a life of 4 years and a salvage of \$100,000. Annual maintenance costs will total \$30,000. The annual labor and material savings are expected to be \$250,000. Use the format in Table 8.1 Calculating the Return Period for Jackson quality copies to calculate the return period. Clearly fine-tune your conclusion. Describe the two main weaknesses of the method of revenue. Solution for Problem Review 8.5 The return period is just over three years, since only \$40,000 is left to be recovered after three years, as shown in the following table. A more accurate calculation can be performed assuming that the cash receipt of \$220,000 for year 4 occurs uniformly throughout the year and the \$100,000 salvage value occurs at the end of year 4. With these assumptions, we simply need to calculate how to months are needed in year 4 to recover the remaining \$40,000. \$40,000 divided by \$220,000 equals 0.18 (rounded). Thus, 0.18 of a year, or approximately 2 months (= 0.18 × 12 months), is required to recover the remaining \$40,000. This more accurate calculation results in a return period of three years and two months. Note that the salvage value is ignored because this cash entry occurs at the end of year 4 when the machine is sold. First, the return method does not consider the value of the money time (no present value or IRR calculations are performed). Secondly, it considers only cash receipts until the cash outflows of the investment are recovered; cash entries after the return period are not part of the analysis. For Chip Manufacturing, Inc., the return period is three years and two months. However, significant cash entries totaling \$280,000 occur after the return period and are therefore ignored (\$280,000 = \$320,000 year 4 cash entries - \$40,000 remaining investment recovered in the first 2 months of year 4). A return period is the time it takes to recover the cost of an investment. Keeping on top of your accounting and billing doesn't have to be a hassle - try Debitoor for free with a 7 day trial! The time required for a period of return on an investment is something to consider strongly before embarking on a project – because the longer that period becomes, the more time that money is lost and the more it negatively affects cash flow until the project breaks down even, or begins to make a profit. What does the return period mean? The return period is typically used to evaluate projects or investments before subjecting them, assessing the associated risk. An investment can have a short or long period of return. A shorter return period means that the investment will be repaid soon, meaning the cost of that investment will be quickly recovered by the cash flow that the investment will generate. Typically, a shorter return period is considered better because it means that the level of investment risk associated with the initial investment cost is only for a shorter period of time. When is the return period favorable? To determine whether the return period is favorable or not, management determines the maximum desired return period to recover the initial investment costs. Depending on the calculated return period of a project, management may decide to accept or reject the project. An investment project is accepted if the return period is less than or equal to the maximum return period desired by management. The simple formula for determining a return period is as follows: Return period = Initial cost investment/cash receipt for this period the example return period The return period is usually expressed in years. You can calculate the return period by accumulating the network flow of the initial negative cash flow until the accumulated cash flow is a positive number. When the accumulated cash flow becomes positive, this is your year of return. There are two methods for calculating the return period, and this depends on whether your expected cash receipts are even (constant) or unequal (changing each year). 1. Return period - even cash receipts If the project cash receipts are uniform, then the return period is calculated by taking the initial investment cost divided by the annual cash receipt. For example: Company A wants to invest in a new project. This project requires an initial investment of £30,000, and is expected to generate a cash flow of £5000 a year. The maximum desired return time is 7 years. Calculation: £30,000 (initial cost) divided by £5,000 (annual cash inflow) = 6 So the return period for this project is 6 years This means that the return period (6 years) is less than the maximum return period desired by management (7 years), so they must accept the project. 2. Return period - irregular cash receipts If the project cash receipts are irregular, then we need to calculate the cumulative cash entry, and use the following formula to calculate the return period: Return period = A + (B/C) Where: A = The last year with negative accumulated cash flow B = The absolute value of the accumulated cash inflow at the end of Year A (the last year with negative accumulated cash flow) C = Total cash flow during the year after year A For example: company B wants to invest in a new project, and the managements of the maximum desired return period is 3 years. The project requires an initial investment of £550 000, and is expected to generate the following cash inflows: Year 1 = £75 000 Year 2 = £140 000 Year 3 = £200 000 Year 4 = £110 000 Year 5 = £60 000 Calculation: Year 0 = -£550 000 Year 1 = £75 000 (- £550 000 + £75 000 = - £475 000) Year 2 = £140 000 (- £475 000 + £140 000 = - £335 000) Year 3 = £250 000 (- £335 000 + £250 000 = - £85 000) Year 4 = £120 000 (- £85 000 + £120 000 = £35 000) Year 5 = £60 000 (£35 000 + £60 000 = £95 000) Payback Period = A + (B/C) Payback Period = Year 3 + (£85 000/£120 000) = 3.7 Therefore, the payback period for this project is 3.7 years. This means that the return period (3.7 years) is more than the maximum return period desired by the administrations (3 years), so they should reject the project. Advantages and disadvantages to the return period method Although the concept of a return period is easy to put your head around, and the information you gain from it is useful for assessing whether a project is a good idea to assume, there are some definite doubts to use the method. Advantages of using a return period calculation: Easy to understand and simple to The risk is considered up front, and it is possible to obtain a clear very quickly about whether investment is a bad idea to begin with. Disadvantages of using a return period method: The money generated from the project after the agreed maximum return period is not taken into account, which means that in some cases a project may be rejected if the return period is the only period taken into account. Requires an arbitrary cut-off point. Money Time Value (TVM) is not taken into account when calculating the return period What is 'Money Time Value' (TVM)? The value of money time (TVM) is the principle that an amount of money at a current time will be worth more at some point in the future. This is due to its budding earning potential (due to the interest that can be earned the faster it is received). In the scenario of calculating a return period, we are looking at projected returns on investment over several months or years, and therefore disregarding what amount of interest could be made. Therefore, this may not give an accurate overall picture of what cash flows will actually be gained for the project. What does the return period for my business mean? For companies, the payback period can serve as a useful way to see how viable a project is. Before you take on a new project or invest the money for a new project, make sure that you are comfortable with the return period that you have set yourself. If a project has the potential to generate new incomes, then it's worth considering, however, only if you can break even – and even better if you can break even before the deadline set! Set!

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