# Lesson Element

# Responding to unseen data – Investment Appraisal

## Task 1 – Investment appraisal calculations – post it

**10 % discount factors**

|  |  |
| --- | --- |
| **Year** | **Discount factor at 10%** |
| **0** | 1.00 |
| **1** | 0.91 |
| **2** | 0.83 |
| **3** | 0.75 |
| **4** | 0.66 |
| **5** | 0.62 |

## Task 2 - Usefulness of investment appraisal techniques – card sorting activity

Cut out the following title cards to create a matching activity.

Payback Period

Average rate of return

Net Present Value

Cut out these strength and weakness cards and decide which method of investment appraisal they apply to.

|  |  |  |
| --- | --- | --- |
| Indicates length of time the capital outlay is at risk | Measures the financial return on a project | Makes an allowance for the opportunity cost of investing |
| Biased in favour of short-term projects | Allows the direct comparison of returns | Takes into account the timing of cash flows |
| Particularly important if firm has cash flow difficulties | Of particular interest to owners/shareholders | Considers the time value  of money |
| Relevant to firms who need  quick returns | Ignores the timing of cash flows | Very difficult to be accurate in  the long term |
| Ignores the timing of cash flows | Does not account for fluctuations in returns | Complex calculations, easily misunderstood |
| Excludes income after payback | Important when profitability, rather than cash flow, is an issue | Does not compare expected returns with the cost of investment |
| Does not calculate financial returns | Shows investment yield | Shows absolute increase/decrease in wealth |
| For valid comparisons to be made options need to have similar levels of start-up capital | Gives percentage return | Takes into account the effects of inflation |
| Of particular interest to banks and other lenders | Calculates returns without relying on the need to choose an accurate discount rate | Can validly compare investments with significantly different amounts of start-up capital |

## Task 3 - Which investment? – Decision-making activity

### Student decision cards

Use these cards to show which project you recommend the company takes in each of the scenarios under consideration.

Project A

Project B

Project C

A company is trying to decide which of three projects to undertake. The results of investment appraisal calculations for the three projects are shown below. Your task is to decide which project the company should choose and present a strong argument for your decision.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Project A | Project B | Project C |
| Initial cost | £440.000 | £60.000 | £120.000 |
| Payback period | 3.25 years | 2 years | 1.5 years |
| ARR | 52% | 100% | 67% |
| NPV (15% discount factor) | £750,000 | £450,000 | £240,000 |

### Part A

|  |
| --- |
| **Which project should the company choose?**  **Explain you reasoning:** |

### Part B

In Part B you are going to consider how a change in a business’ circumstances may affect investment decisions. Consider each of the scenarios in turn. Explain how the circumstances affect the investment decision. Decide which project the company should take and justify your view.

### Scenario 1

**The company is experiencing significant cash flow difficulties which are affecting its ability to gain further finance from its bank.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning:

### Scenario 2

**Many of the company’s shareholders are threatening to sell their shares if share dividends do not increase in the next few years.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning:

### Scenario 3

**The company is new and the shareholders are willing to take risks for potential high returns.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning:

### Scenario 4

**The directors of the company are risk averse. They are cautious and experienced. Option C involves diversification.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning:

### Scenario 5

**The company operates in a market which is subject to rapid change, especially beyond year 3. The company has no cash flow problems and the investors want high returns.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning:

### Scenario 6

**The company trades on its ethical and socially responsible branding. Project B would not be perceived by the public as environmentally friendly.**

What affect might this scenario have on the company’s investment decision?

Which project should the company choose?

Explain your reasoning: