

What is Investment Appraisal?

Worksheet

Investment appraisal is the process of assessing capital investments using financial methods (NPV, ARR, payback period, IRR) to determine profitability, risk and strategic fit.

$$NPV = -I_0 + \sum_{t=1}^n \frac{CF_t}{(1+r)^t}$$

Questions

1. Payback period is most useful for assessing...

- A) long-term profitability
- B) liquidity and capital recovery speed
- C) inflation impact
- D) market share growth

2. NPV is preferred by theorists because it...

- A) is simple to calculate
- B) ignores the time value of money
- C) accounts for the time value of money
- D) has no calculation needed

3. A 100,000 investment yields 20,000 annually. Payback period is...

- A) 3 years
- B) 5 years
- C) 4 years
- D) 2 years

4. Which method ignores the time value of money?

- A) NPV
- B) IRR
- C) ARR
- D) Discounted payback

5. A company invests 100,000 and receives 30,000 annually for 5 years. Calculate the payback period.

6. Project A costs 50,000; Project B costs 80,000. Both yield profits. Which metric helps choose between capital-constrained options?

7. A project requires 90,000 investment and yields 40,000 annual profit for 3 years. Calculate ARR.

8. Define: What is investment appraisal?

9. Define: Name four investment appraisal methods.

10. Define: What does payback period measure?

Answer Key

1. B) liquidity and capital recovery speed - Payback period shows how quickly capital is recovered - important for liquidity-conscious firms. It does not assess long-term profitability.
2. C) accounts for the time value of money - NPV discounts future cash flows to present value, reflecting that money's worth changes over time.
3. B) 5 years - Payback = $100,000 / 20,000 = 5$ years.
4. C) ARR - ARR treats all profits equally regardless of when they occur; NPV and IRR adjust for timing.
5. Annual cash inflow = 30,000 Years to recover 100,000 = $100,000 / 30,000 = 3.33$ years Payback period = 3 years 4 months (0.33 \times 12)
6. Use profitability index = NPV Initial outlay Higher profitability index = better return per invested Or calculate NPV for each and choose highest NPV
7. Total profit = 40,000 \times 3 = 120,000 Net profit = 120,000 - 90,000 = 30,000 ARR = $(30,000 / 90,000) \times 100 = 33.3\%$
8. The process of assessing capital investments using financial methods (NPV, ARR, payback, IRR) to evaluate profitability and risk.
9. NPV (net present value), ARR (average rate of return), payback period, and IRR (internal rate of return).
10. The time (usually in years) required to recover the initial capital investment from cash inflows.

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