Investment Evaluation Difficulties

B. C. Gomoi

Bogdan Cosmin Gomoi
Faculty of Economics, "Aurel Vlaicu" University of Arad, Romania

Abstract
The financial criteria used for evaluation of the enterprise are not numerous; however, they are causing heated discussion on whether using a criterion at the expense of another.

The most utilized financial criteria used in the ranking of investment alternatives are: the net present value criterion, the internal rate of return criterion, the payback period limit criterion and last, but not least, the profitability index criterion. These criteria have in mind, in the first place:

- *investments impact on enterprise profitableness and results*, by recording the future positive cash-flow
- *investments influence on the balance of an enterprise*, traced through the evolution, on one side of the working capital\(^1\), on the other hand, the size of necessary working capital\(^2\)
- *incidence of the investment project on enterprise risk level*\(^3\)

Therefore, to ensure the best possible decision making, investors must choose of using, and why not, even construction of relevant indicators regarding the opportunity of an investment decision in one alternative or another. It is advisable to take into account a number of

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\(^1\) an investment requires an initial allocation of capital which affects the size of working capital

\(^2\) through investment, working capital necessary variation is positive and permanent, the expected conditions of growth divided over the entire period of the project

\(^3\) payments related to investments affects enterprise treasury in real, in the context of a series of future uncertain cash-flows operations
principles, which are nothing more than to highlight various aspects of technical analysis of investment projects. As a result, it is preferable not to neglect the value of money in time problem, solved by using dynamic indicators of investment; investment project analysis with reference the binomial risk - profitableness, ensuring that profitableness of an investment is directly proportional to the risk category in which is framed; the basis for the investment decision to materialize with the help of marginal cash flow analysis and, certainly not with the help of paper profits; taking into consideration the fiscal policy of the company; elimination of the inflationary phenomenon in the decision process; targeting of low risk investment projects, because this risk adds to the whole risk of the enterprise etc.

Keywords: investment, evaluation, difficulty, financial criteria, IRR

Internal Rate of Return

Internal rate of return on an investment is the capitalization rate of the analyzed investment project’s cash-flow, which equals the net present value of the initial investment value. Under a more practical expression form, internal rate of return can be defined as the capitalization rate that equals the value totaling the cash-in-flows investments with the initial value of the investment.

To calculate the internal rate of return (IRR) on an investment, whether we are talking about an IRR of financing, or about an IRR of investing, assuming a single sum of initial capital invested, we use the relationship:

\[ I_0 = \sum_{t=1}^{n} \frac{CFD_t}{(1 + IRR)^t} + \frac{RV_n}{(1 + IRR)^n} \]

where CFD is the size of future investment’s cash-flow, \( RV_n \) is the residual value of investment at the end of its period, and \( I_0 \) is the initial investment. Further we neglect size residual value.

From the definition we see that the internal rate of return uses upgrade technique to bring future cash flows to present, as their value significance.

\[ ^4 \text{cash-in-flows are positive and cash-out-flows are negative} \]
For example, an investment that last 10 years, releasing a table of cash flow, summarized in the table below, according to an initial investment of 3,500 lei:

<table>
<thead>
<tr>
<th>CFD1</th>
<th>CFD2</th>
<th>CFD3</th>
<th>CFD4</th>
<th>CFD5</th>
<th>CFD6</th>
<th>CFD7</th>
<th>CFD8</th>
<th>CFD9</th>
<th>CFD10</th>
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<tbody>
<tr>
<td>800</td>
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<td>850</td>
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</tr>
</tbody>
</table>

Under these conditions, internal rate of return is unique; at the rate of 18.43%, due to variations of a single sign of investment flows, considering that the initial investment was introduced into the calculation with the sign -.

By this discount rate, net present value is expressed in terms of percentage return, indicated value\textsuperscript{5} being greater than the percentage of 15%. The impact of one investment’s internal rate of return over its policy in maximizing enterprise value is also emphasized by the net present value profile, which, practically, represents graphic of NPV variation to percentual change of cash flow discount rate.

Determination of IRR solution is difficult enough, especially under the conditions where we refer to a long period of investment project, its calculation being reduced to solution of a polynomial equation of degree n. Therefore, either we calculate by repeated attempts either we use the interpolation method. According to this method, internal rate of return of an investment is being estimated under the relation

\[
IRR = k_{\text{min}} + \left(k_{\text{max}} - k_{\text{min}}\right) \cdot \frac{NPV_+}{NPV_+ + |NPV_-|}
\]

Where \(NPV_+\) positive net present value of is minimum, \(NPV_-\) is negative net present value of minimum, \(k_{\text{min}}\) is discount rate proper to the minimum \(NPV_+\), \(k_{\text{max}}\) is discount rate proper to the maximum \(NPV_-\). For this we must calculate a net present value set according to several discount rates. However, the calculations do nothing more than to set approximate levels on internal rate of return of the investment analysis. Salvation comes from information technology, which provides various programs for calculating the indicators of this nature. A solution would

\textsuperscript{5} according to BIRD, methodology of analyzing investment projects
be the utilization of $\text{IRR} \ (\text{Values}; \text{Guess})$ function, offered by Excel spreadsheet program.

**Rationality IRR**

Investors and the enterprise concept of internal rate of return vary. *Investors* perceive the IRR as the *minimum level of achievable profitability* on an investment, while the enterprise translates internal profitability indicator as the *minimum cost of invested capital*. Also, the investor wants to recover his initial investment in a short period, but the enterprise aims to minimize the cost of initial investment by rescheduling on a longer period with a smaller net present value. Because the asymmetry of information is present in the market economy, investors adopt a pessimistic attitude, but they trace maximizing the most unfavorable options in future enterprise value. In contrast, the company stands at the opposite end, approaching an optimistic attitude, to determine the investor to place his equities in projects of the enterprise. All this shapes a truly strategic game, each player watching the moves of the others. The two divergent optical, translated into the language of decision theory are expressed for the investor the form $\text{IRR}_\text{investor}^{\text{optimum}} = \max\left\{ \min\left(\text{cash flow}_{\text{investment}} = I_0 \right) \right\}$ and for enterprise $\text{IRR}_\text{enterprise}^{\text{optimum}} = \min\left\{ \max\left(\text{cash flow}_{\text{investment}} = I_0 \right) \right\}$. Therefore, only the managers of the enterprise are responsible with identification of equilibrium IRR.

As a result of what was said, the internal rate of return is a relevant criterion for the selection of investments, considering the average *interest rate* $r$, as the reference yield. Conformable to this criterion, a rational investor will choose the investment whose rate of return is more than the average reference interest rate $\text{IRR} > r$, choosing to maximize the value of this indicator. In other words, internal rate of return can be analyzed from several angles:

- as the cost of capital employed in the investment;
- as an opportunity cost in relation to competing investment alternatives;
- as a form of minimum accepted profitability.

Reason of IRR criterion starts from the marginal analysis of future benefits corresponding to two or more investments belonging to different risk classes. An investor will choose for a risky investment as
long as the risk taken will be paid in his subjective limits of aversion against the risk. I pointed this reasoning, since a revelation of desire to obtain a maximized IRR by the investor is practically limited by investor’s aversion to risk, without questioning an expected IRR rates virtually infinite anticipated.

The problem of applying the IRR criterion for assessing the investment is raising serious questions on relevant information revealed by this indicator, given that we refer to the informational value of the NPV criterion.

Contradictory results
Determination of the importance of IRR criterion among other criteria used in evaluating investments is an extremely difficult step, the discussion starting on assumptions which started conceptualization of internal rate of return indicator and also from a series of mathematical properties of the present value function.

Need for such an approach is useful because a simultaneous use of two assessment criteria cause decision-making situations conflict. In the case of independent investment projects, application of the IRR and NPV criterion generates the same result decision. Difficulties arise when investment projects are excluded in which case the size and different time cycle are giving birth to incompatibility of results of the two investment criteria evaluation.

Although, in practice most managers use IRR criterion in financial investment decision, conceptually speaking, the NPV criterion is much better built, especially in terms of finality, and namely the reflection and measure of enterprise value maximization.

The best solution to clarify the conflicting moods aroused by the incompatibility with the IRR or NPV elections is the combined use of these criteria noting that the relevance of the IRR is deeply affected by multiple methodological flaws and interpretation. Therefore, as the prime criterion in evaluating must be used the net present value criterion, and as a criterion for choosing between investments with the same NPV we use IRR criterion.

Also, it is essential to mention that a comparative analysis of the results of the two evaluation criteria is not meant for validation of any of the alternatives investment.

If an investment project has a \( \text{NPV} > 0 \) and an \( \text{IRR} > k \), the project is validated. But in the case of investments that exclude each
other, decisional conflict will occur in case NPV criterion nominates as one of the appropriate investment, and through the IRR criterion is decided on other investments. Equally, the need of hierarchy investments, in terms of budget restriction, is solving in-depth analysis of all investments, by choosing investments with net present value or internal rate of return in maximum.

Next we discuss the case of investments I-IX, whose cash flows are presented in the table below:

<table>
<thead>
<tr>
<th></th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>V</th>
<th>VI</th>
<th>VII</th>
<th>VIII</th>
<th>IX</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3500 lei</td>
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<td>-750 lei</td>
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<td>2145 lei</td>
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<td>1400 lei</td>
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<tr>
<td>400 lei</td>
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<td>1800 lei</td>
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<td>400 lei</td>
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<td>1200 lei</td>
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<td>100 lei</td>
<td>250 lei</td>
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</tbody>
</table>

**Relativism of IRR criterion**

According to the basic objective of company’s finances, enterprise value maximization can be achieved only by optimally-useful allocation of available funds in investment that provide maximum benefits. It is true that the minimum rate of return on an investment reveals the possibility of obtaining an added value in the future, compared with the initial investment, but net differentiation in favor of NPV criterion is the absolute impact on enterprise value, and not an impact on relative sizes.

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6 where investments are indivisible
For instance, an investor chooses, rather, the investment V, with a net present value of 3.054 lei and an internal rate of return of 33.43%, than the investment IV with a net present value of 699 lei, but a rate of 48.76% IRR. Priority desideratum is to increase the wealth of enterprise shareholders; therefore the NPV criterion is the most indicated.

**Conflict Zone**

In the figure below the NPV curves of two investments I and II are graphically represented. Through updated cash flow technique, it achieves a more severe reduction of their future value. Therefore, we see that the IRR rate lower than the corresponding rate curves intersection of the two investment NPV, conflicting situations arise between IRR and NPV criteria.

Thus, at a discount rate of future cash flows of the two investments, lower than level of 13.55%, we will have a net present value of investment I smaller than of investment II, although the IRR for the investment rate I (20.21%) is higher than the rate of investment II (16.86%). However, if future cash flows investments are updated at a higher discount rate meeting point of two curves will be able to proceed with analysis of individual investment projects using the two criteria, and the results will converge to the same conclusion.

**Investment Size**
Let’s analyze the present value of the investment profile graphic XI and X. The investment IX is characterized by an IRR of 61.60% and a NPV of 1074 lei, while investment in X is defined by a net present value of 457 lei and a 36.35% IRR rate.

The magnitude of one investment affects alternatives investment evaluation from internal rate of return criterion perspective, once again due to the relative character of rates of return. Through an analysis of marginal cash flows, under the assumption that investment IX is an additional investment relative to investment X, we get the marginal cash flows:

<table>
<thead>
<tr>
<th>CFDm1</th>
<th>CFDm2</th>
<th>CFDm3</th>
<th>CFDm4</th>
<th>CFDm5</th>
<th>CFDm6</th>
<th>CFDm7</th>
<th>CFDm8</th>
<th>CFDm9</th>
<th>CFDm10</th>
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<tbody>
<tr>
<td>500 lei</td>
<td>350 lei</td>
<td>50 lei</td>
<td>100 lei</td>
<td>100 lei</td>
<td>150 lei</td>
<td>350 lei</td>
<td>-100 lei</td>
<td>-150 lei</td>
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</tbody>
</table>

Given that initial marginal investment is 750 lei, we obtain a net present value of marginal investment IX-X of 182 lei, reflected under the return of return’s values of 28.02%. Because the marginal rate of return is higher than average interest rate by reference assumed of 15%, we can sustain that the investment project X is preferred to the detriment of investments X.
VIII

The value of only 217 lei can obtain a project for five years return. Therefore, only 35.53%.

VII

Profitable projects with different life times are higher than those of other investments, whereas in the case of cash flows investments, available that could place in other future investments, obtaining a higher net income than gains from other investments, because by update, with the passage of time, money today is worth less than tomorrow.

IRR criterion sets a trap to analysts under the analysis of profitable projects with different life times. For instance, investment VII, achieved on a period of 10 years, has an internal rate of return of 34.54%, inferior to internal rate of return of investment VIII that is of 35.53%. But investment VIII is planned to be achieved over a period of only 5 years. It would be wrong to consider investment VIII more feasible than investment IX, only on account of the internal rate of return. Therefore, if we calculate the net present value for only the first five years of investment under the case of investment VII, we will obtain a project VII internal rate of return of 23.17% and a net present value of only 217 lei, compared with net present value of investment VIII.

<table>
<thead>
<tr>
<th>Conflict zone</th>
<th>Multiple IRR</th>
<th>Size of investment</th>
<th>Absence of IRR</th>
<th>Duration of investment</th>
<th>Investment Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>55 %</td>
<td>-1179 lei</td>
<td>-1578 lei</td>
<td>-1 lei</td>
<td>-34 lei</td>
<td>-987 lei</td>
</tr>
<tr>
<td>60 %</td>
<td>-1219 lei</td>
<td>-1592 lei</td>
<td>-2 lei</td>
<td>-55 lei</td>
<td>-1082 lei</td>
</tr>
<tr>
<td>65 %</td>
<td>-1246 lei</td>
<td>-1595 lei</td>
<td>-4 lei</td>
<td>-71 lei</td>
<td>-1152 lei</td>
</tr>
<tr>
<td>70 %</td>
<td>-1265 lei</td>
<td>-1590 lei</td>
<td>-6 lei</td>
<td>-83 lei</td>
<td>-1202 lei</td>
</tr>
<tr>
<td>75 %</td>
<td>-1275 lei</td>
<td>-1580 lei</td>
<td>-8 lei</td>
<td>-92 lei</td>
<td>-1238 lei</td>
</tr>
<tr>
<td>80 %</td>
<td>-1281 lei</td>
<td>-1565 lei</td>
<td>-10 lei</td>
<td>-99 lei</td>
<td>-1262 lei</td>
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<tr>
<td>85 %</td>
<td>-1281 lei</td>
<td>-1547 lei</td>
<td>-12 lei</td>
<td>-105 lei</td>
<td>-1278 lei</td>
</tr>
<tr>
<td>90 %</td>
<td>-1279 lei</td>
<td>-1527 lei</td>
<td>-15 lei</td>
<td>-109 lei</td>
<td>-1287 lei</td>
</tr>
<tr>
<td>95 %</td>
<td>-1273 lei</td>
<td>-1506 lei</td>
<td>-17 lei</td>
<td>-112 lei</td>
<td>-1290 lei</td>
</tr>
<tr>
<td>100%</td>
<td>-1265 lei</td>
<td>-1484 lei</td>
<td>-20 lei</td>
<td>-114 lei</td>
<td>-1290 lei</td>
</tr>
</tbody>
</table>

B. C. Gomoi
Therefore whole the net present value criterion is the most relevant indicator of discrimination against investments, investments more or less feasible.

**Reinvestment to constant rate**

Internal rate of return was defined as being the discount rate of cash flow investment analysis, to cover the full amount of initial investment. But it went wrong at least realistic assumption of constant reinvestment under the same company and at the same IRR of future cash flow.

To solve this it proceeded to accept the assumption of reinvestment of future benefits at a rate of return of the enterprise, and not of investment project, by the size of enterprise capital cost. Modified internal rate of return, abbreviated MIRR is being calculated by the relationship:

\[
MIRR = \sqrt[n]{\frac{\sum_{j=1}^{n} CFD_j \cdot (1 + d)^{n-t} + RV_n}{I_0}} - 1 ,
\]

where \(d\) is enterprise specific rate of return that can be reinvested future cash flows.

Clearly as the size of internal rate of return depends directly of positioning of the IRR from benchmark rate stock market \(d^7\), representing the average interest rate on risk-free securities, as shown from the values below:

<table>
<thead>
<tr>
<th>(d)</th>
<th>10.00%</th>
<th>15.00%</th>
<th>20.00%</th>
<th>25.00%</th>
<th>30.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>(MIRR_I)</td>
<td>13.70%</td>
<td>16.85%</td>
<td>20.07%</td>
<td>23.36%</td>
<td>26.71%</td>
</tr>
<tr>
<td>(MIRR_{II})</td>
<td>13.79%</td>
<td>16.00%</td>
<td>18.34%</td>
<td>20.80%</td>
<td>23.37%</td>
</tr>
</tbody>
</table>

It can be noticed that as long as the enterprise reinvestment rate is higher IRR rate, we will achieve modified growth rates of return. But rates of reinvestment lower than IRR generate increasing diminution of the modified internal rate of return.

**Multiple solutions**

Another problem utilizing IRR in investment selection is the multiple solutions problem. This problem occurs only if the investment

\(^7\) considered as the minimum rate of return required of shareholders
projects whose cash flow varies in the future, as an algebraic sign, from one period to another. The situation can be met if there is need for additional investment in the future, whether it's legal obligations, or extensions of the life of the investment.

As we can see in the graphic, the NPV curve that characterizes investment III, cuts the x-axis in three points, meaning the investment has three internal rates of return. They are determined by solving the mathematical equation of degree 10 polynomial.

In the case of the investment III we get three internal rates of return because we have three shifts of signs concerning the evolution in time of cash-flows. For the first internal rate of return is being used the function IRR of the Excel spreadsheet program, but the problem arises when determining the other two unknown rates of return. For this we will use the method of calculating the IRR through interpolation with the relation

$$\text{IRR} = 25\% + (30\% - 25\%) \cdot \frac{1}{1+[-1]} = 27.5\%.$$  

Analog will obtain the last value multiple of 52.5% IRR.

In these cases, abandon the use of the IRR criterion of investment evaluation considering it viable for the net present value criterion.
**IRR absence**

Due to mathematical construction from which we started determining the internal rate of return, we’ve come to the situation where determining this kind of rate is difficult, at the expense of solving polynomial equation resulting from equating the net investment with present cash flow sum and with unknown IRR.

There are situations in which the equation that was just mentioned doesn’t accept real solutions; therefore, we’re assisting at an evaluation project of investment characterized through the absence of internal rate of return.

In this case, investment VI is characterized by strictly negative net present values, in case we go through the interval of discount rates [5%-100%].

![Net present value profile](image)

If the discount rate tends to a very high value, present coefficient tends to the initial value of investment, which causes the gradual cancellation of the importance value discounted cash-flow. This behaviour can be described more than a perpetual investment in the scheme,\(^8\) in which case the present value of cash-flows is given by

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\(^8\) project length tends to have high values, and cash-flow average describes and parallel to the x-axis
\[ NPV = \frac{CFD}{IRR} - I_0. \]

In addition to this asymptotic behaviour arises the financial practice problem, which doesn’t look at situations of very high profitableness, since such situations are impossible at the level of analysis in absolute values.

**Conclusions**

An investments internal rate of return has won an important place in decision making in the analysis of financial practices of the largest enterprises. But scientific research has shown that such a criterion is relevant only in terms of comparative analysis of independent investment projects, those you can use assessing the feasibility of investment into the truth of the relationship \( \text{IRR} > d \). Also, a depth analysis of investment projects can be used as a useful tool in their classification, given that the economic situation imposes restrictions on enterprise financing. Therefore, indivisible priority projects\(^9\) that are intended to be done are those projects with the highest values of the internal rates of return.

A use for the IRR criterion raises numerous conflicting situations, starting from incompatibility of the results obtained through evaluation using the IRR criterion and, also, NPV criterion. Conflicting statements are limited to investment projects whose related net present values curves intersect. Also, methodological insufficiencies make their way in the valuing of information offered by the application of the IRR criterion for investment evaluation: multiple IRR solutions, IRR absence, or the unrealistic assumption of reinvestment of future benefits at a constant rate of non-specific general business risk and profitability enterprise etc.

All these remarks don’t have as purpose minimising the informational value of the internal rate of return, but only to draw a fine attention to the weaknesses and traps set by utilising this indicator.

**Bibliography**


\(^9\) if we analyse dividable investment projects, we will be able to make a portfolio of investments, in which the problem is to determine the structure vector of the portfolio’s components, that have to assure a maximisation of enterprise value either through by designing an objective function of maximum internal profitability, or utilising a function of net present value hope

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