How do you explain the internal rate of return to a layman.docx

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How Do You Explain the Internal Rate of Return to a Layman?

Its common knowledge that money lenders load a certain profit margin on every coin they lend out as a means of obtaining a reward for the risks involved in money lending. The activity is purely business and is acceptable. With the financial institutions, one rule remains constant; the more the amounts lent out as loans, the higher the interest rates and a true converse is true.

When it comes to companies and investments, analysis and valuation of target projects are critical to investment. Managers, therefore, must scrutinize the plans on the table to gauge and find out the return rates of each project. Why? To know the most promising and most profitable, thus giving it a priority.

It's the role Internal Rate of Return to help the management of companies to determine projects that meet their rate of return. In this case, a plan becomes viable only if it's exceeding the investors' desire return rates, and if otherwise, it's unviable and shelved.

In simple terms, Internal Return Rates renders the net current all the cash flow, whether negative or positive, of an investment project equivalent to zero or rather a rate of discount employed in capital budgeting that makes all the current net cash flows from projects in question equal to zero. Therefore, it's wise to choose a plan with a higher IRR rate whenever you're evaluating projects that are mutually exclusive, and it remains the ultimate tool used by accountants for small businesses that intend to acquire more resources as well as investing in other projects.

The formula
Initial Cash Outlay + Present Value of All Future Cash Inflows = 0

Having known that one side of the equation is zero, let's find out why the case is so. Whenever evaluating investment projects, the high IRR rates indicates a vibrant growth potential of the business in the future.

Two sides of the coin

In any business set up, profits or losses are the only two possibilities that investors may bump into at the end of the day. The IRR valuation and percentage calculation well depict the case.

A negative percentage means that the investment project won't manage to bring back the investment. The converse of this, a positive rate, is an indicator that the investment will bring back the investment plan.

Example

For a better understanding of the concept, consider the case below;

If you loan me $100 today, would you be comfortable to get the similar amount as a repayment a year later?

The answer is a definite "NO!"

Simply because inflation is an inevitable factor in every economy, the value of the amount loaned shall never be the same in a year's time. Moreover, there could prevail a plum opportunity cost for you to invest your $100, yielding you good profits.
Therefore, you'll want something more than the amount lent out at the end of the year, maybe $105 or so. According to this, the IRR is 5%; meaning that the higher the amount invested, the more top the returns and a true converse.

The same case applies to companies desiring to invest. They won't risk their money into investments that won't bring back their money plus reasonable profits. They, therefore, assess and evaluate the looming investment opportunities using the Internal Return Rates to pick up the most promising project.

**Decision Making**

Through calculation of profit percentages, the IRR makes decision making a simple task to the investors. The management of the investing companies select a few investment opportunities and compare their profit percentages and pick one of their choices.

The board of management then decides which investment program to embrace from the options availed to them by the evaluator and with this illustration, a layman can confidently confine himself or herself in a meeting [Weaccountax accountants for small businesses near me](#) and discuss business.