The Payback Rule

The payback method is a popular capital budgeting technique used by financial managers. It is defined as the time it takes to "payback' the initial investment. Let's quickly demonstrate this technique through an example:

[Example:](#) A firm has found the following two projects. Based on the payback method which project should the firm choose?

Project	Initial Investment	Year 1	Year 2	Year 3	Year 4
Alpha	- 250,000	150,000	50,000	30,000	100,000
Beta	- 250,000	100,000	100,000	100,000	100,000

Answer:

Time	Amount to be "paid back"	
	Project Alpha	Project Beta
Year 0	250,000	250,000
Year 1	100,000	150,000
Year 2	50,000	50,000
Year 3	20,000	-50,000
Year 4	-120,000	

Payback Period = Number of years + $ not yet paid in final period of "payback"/Cash flow during final year of payback

Payback of Project Alpha = 3 +20,000/100,000 = 3.2 years

Payback of Project Beta = 2 +50,000/100,000 = 2.5 years

The payback period of project beta is shorter than the payback period of project alpha. Therefore using this capital budgeting technique, project beta would be preferred.