Overview

Online services companies are different from other services companies in a lot of ways. Such companies differ in terms of their operations, reporting of their numbers, as well as the cash flow recording methods. Also, since these companies differ in so many ways, it is not a straightforward process for potential investors to calculate the expected returns on their investments. Therefore, it is important to understand the strengths and weaknesses of investment appraisal techniques for online services companies. Some of the techniques used for investment appraisal are: net present value (NPV), internal rate of return (IRR), accounting rate of return (ARR), and Payback Period (Hirschey et al., 2002).

Key Strengths

The primary strength of investment appraisal techniques in the case of online service companies is that they can be very easy to comprehend for any potential investors. This is because these techniques do not require advanced accounting knowledge. Carey et al. (2017) analysed an example of an online sports company to assess accounting procedures and forecasts for the purpose of investment appraisal. For an online business, the calculation for investment appraisal is fairly simple to understand. The research study estimated the cash inflow that would be accrued each year and then estimated how much time would be required to recoup the investment. Since online businesses are simply based on the concept of cash, accruals, and expenses, they can be fairly simple to project in financial terms. The scholars also noted that expense allocation for website development could be straightforward as the primary costs involved are invested upfront (Carey et al., 2017).

Further, techniques such as NPV can paint a fairly accurate picture in terms of taking into account the inflation rates. This is because such investment appraisal techniques are based on discounted cash flows. This means that future cash flows are usually discounted to their present value. This provides a more accurate result compared to a direct financial forecast which is just based on the linear growth of key figures. In the case of online services, this can be extremely helpful since distant cash flows that will occur in the future are taken into account. By discounting these cash flows to their current values, the impact of market rates is also being negated (E-Finance Management, 2018). However, another aspect is that inflation rates and discounted cash flows are not too relevant in the case of e-commerce businesses. The e-commerce sector within online services companies relies more on goodwill, and thus the appropriate method for investment appraisal should be multiple earnings method. The biggest strength of this method is that it takes into account the goodwill factor (Digital Commerce 360, 2014).

Another key strength of investment appraisal techniques in case of online services companies is that most of these companies have an online business reporting system. This can be beneficial in delivering financial and non-financial metrics to investors on a timely basis. Further, the key advantage of such a system is that the chances of errors in financial numbers become minimal compared to offline businesses which follow manual ledgers. This ensures that the investment appraisal is more accurate and captures the metrics more effectively. Thus, the appraisal and cash flow forecasts can be much more accurate in cases where the reporting mechanism is online-based (Basoglu and Hess, 2014).

Key Weaknesses

One of the key weaknesses of investment appraisal techniques in the case of web services companies is that costs and benefits can be hard to quantify. This is because the technology aspect keeps changing with time, and there are no guarantees as to whether the company will be able to keep up with the overall pace set by the industry. Further, it is to be noted that in many cases, the estimation of cash flows for such companies may be accurate but not complete. This is because, in the online services sphere, it is not always a straightforward process to estimate steady revenue streams. Another aspect which could be a potential weakness is that the nature of the web-based marketplace is so complex that it can be hard to assess growth patterns. There are cases when investors forecasted a consistent growth, but this did not materialise as per plans (Sims et al., 2015). Another potential weakness is that all traditional accounting methods may not be suitable for internet services businesses because of their unique operating model. Such enterprises rely less on physical assets and more on intangibles; therefore, rendering traditional accounting less meaningful compared to other industries (Siddiqi et al., 2002).

Another weakness of traditional investment appraisal techniques for online services companies is a lack of sufficient financial information. This is especially true in the case of startups and online community-based businesses (Barrett et al., 2016). In these organisations, financial metrics can be replaced by web metrics. In such cases, potential investors need to look at other indicators such as tangible and intangible assets, research and development (R&D) estimates, as well as subscriber growth numbers. Alternatively, a mix of financial and non-financial metrics could be used for the purpose of investment appraisal. The financial estimates would include the usual indicators such as costs and cash flows, while the non-financial estimates would include an analysis based on economics and resource flows (Benefit Cost Analysis, 2014). Although the usage of such metrics is not uncommon, they can paint a very different picture compared to the traditional accounting appraisal techniques (Serrano-Cinca et al., 2005).

Conclusion

In summary, it is clear that the investment appraisal for online services companies is not a straightforward process. There are a number of strengths and weaknesses when it comes to estimating the cash flows as well as the expected returns for such companies as they have unique business models compared to traditional industries. Therefore, all potential investors need to be careful and ensure that the most appropriate technique is utilised for predicting the future cash inflows for such companies. Further, the method of recording used by the firm should also be taken into consideration in order to ensure that the future cash flow estimates are accurate.

References

Barrett, M., Oborn, E. and Orlikowski, W. (2016) Creating value in online communities: The sociomaterial configuring of strategy, platform, and stakeholder engagement, *Information Systems Research*, *27*(4), pp.704-723.

Basoglu, K.A., and Hess, T.J. (2014) Online business reporting: A signaling theory perspective, *Journal of Information Systems*, *28*(2), pp.67-101.

Benefit Cost Analysis (2014) Accounting for Market Distortions in an Integrated Investment Appraisal Framework, available at <http://benefitcostanalysis.org/sites/default/files/public/C5.1_Bagzibagli%20BCA%20Society%20Conference%202015%20-%20March%2020%20-%20Session%205%20-%20Room%20C_0.pdf> [Accessed on 13 December 2018].

Carey, M., Knowles, C. and Towers-Clark, J. (2017) *Accounting: a smart approach*, New York: Oxford University Press.

Digital Commerce 360 (2014) What is your e-commerce business worth, available at <https://www.digitalcommerce360.com/2014/08/18/what-your-e-commerce-business-worth/> [Accessed on 13 December 2018].

E-Finance Management (2018) Why Net Present Value is the Best Measure for Investment Appraisal?, available at <https://efinancemanagement.com/investment-decisions/why-net-present-value-is-the-best-measure-for-investment-appraisal> [Accessed on 13 December 2018].

Hirschey, M., John, K., and Makhija, A.K. (2002), *Innovations in Investments and Corporate Finance*, Yorkshire: Emerald Publishing.

Serrano-Cinca, C., Fuertes-Callén, Y. and Mar-Molinero, C. (2005) Measuring DEA efficiency in Internet companies, *Decision Support Systems*, *38*(4), pp.557-573.

Siddiqi, J.I., Akhgar, B. and Aked, G. (2002) Investment Appraisal and Business Benefits for E-Enterprises, *ICWI, 1*(1),pp. 271-275.

Sims, J., Powell, P. and Vidgen, R. (2015) Investment appraisal and evaluation: preserving tacit knowledge and competitive advantage, *International Journal of Business and Systems Research*, *9*(1), pp.86-103.