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Technical Note

Prepurchase financing pool: Revealing the *IRR* problem

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ABSTRACT

Internal rate of return (IRR) is one of the most common and important indicators in investment analysis because it is often used by managers and practitioners as a decision-making criterion. Moreover, the IRR reflects the financial cost in financing decisions and it helps to answer the following question when comparing different financing alternatives: “Which loan is the cheapest?” Among the different types of loans in Brazil, there is a financial product called a prepurchase financing pool (PPFP) that is generally regarded as the best option for financing or loans. The objective of this article is to use the prepurchase financing pool to show the flaws of IRR in financial analysis. In particular, when IRR is used to evaluate the prepurchase financing pool, one finds problems of reliability regarding (i) existence, (ii) uniqueness, and (iii)

economic interpretation of the rate. The results show that the prepurchase financing pool is relevant evidence that the IRR flaws are found in financial products.

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