QUIZ 2

I. True or False

1. All anticipated cash coming into or going out of the firm as a result of a capital investment should be used in capital budgeting decisions.
2. A firm short of cash might well give greater emphasis to the payback period in evaluating a project.
3. An investment with a short payback period is almost certain to have a positive net present value.
4. The net present value of a project generally decreases as the required rate of return increases.
5. A mutually exclusive project is one whose acceptance does not preclude the acceptance of alternative projects.
6. Use of the IRR method implicitly assumes that the project's intermediate cash inflows are reinvested at the required rate of return used under the NPV method.
7. If a project's cash flows are discounted at the internal rate of return, the NPV will be zero.
8. All three major discounted cash flow methods of evaluation will consistently give the same desirability ranking to a series of projects.
9. By accepting projects with relatively high degrees of positive correlation with other company projects, a firm may be able to lower its risk.
10. A managerial option is simply the flexibility of management to change a previously made decision.

II. Multiple Choice

1. Which one of the following items should *not* be included when estimating cash flows for an investment project?

A. The initial investment outlay

B. Sunk costs

C. Additional working capital requirements

D. Opportunity costs

E. Incidental effects on the remainder of the business

2. An investment project requires an initial outlay of $5m and has expected end-of-year cash inflows of $725,000 for ten years. At the end of the project a $500,000 salvage value is anticipated. This project has an internal rate of return of

A. 6%

B. 7%

C. 8%

D. 9%

E. 10%

3. Which one of the following items should *not* be included in the cost of a new machine in a budgeting analysis ?

A. The undepreciated capital cost of $1,000 for the existing machine.

B. Special inventory of spare parts for the new machine costing $2,000.

C. Transportation costs of $500 for the new machine.

D. Installation costs of $200 for the new machine.

E. Provincial sales tax on the new machine.

4. Which one of the following statements does *not* correctly describe the valuation of proposed investments?

A. The opportunity cost of capital is used as the discount rate to calculate the present value of expected cash flows.

B. The present value of the expected cash flows reflects the maximum price to pay today

C. If the net present value of is zero, no new wealth creates by undertaking the investment.

D. If the net present value of an investment exceeds zero, the investor earns less than the expected rate of return.

E. Expected cash flows are estimated on an after-tax basis.

5. At the end of the project, the residual value should considered on following basis

i) the gain on the sale of the equipment

ii) after-tax cash flows

iii) cash realized minus cash paid for the selling the equipment

iv) discount rate is equal to or higher than weighted average cost of capital

A. i) and iv) only

B. ii) and iv) only

C. iii) and iv) only

D. ii), iii) and iv) only

E. i), ii), iii) and iv)

6. An investment project should be accepted if:

A. The internal rate of return exceeds the cost of capital.

B. The profitability index exceeds zero.

C. The net present value is negative.

D. The average rate of return exceeds the cost of capital.

E. The payback period exceeds zero.

7. Which of the following does not consider the time value of money ?

i) payback period

ii) breakeven analysis

iii) internal rate of return

iv) profit index

A. i) only

B. i) and ii) only

C. i), ii) and iii) only

D. i) , ii) and iv) only

E. i), ii), iii) and iv)

8. The initial investment is $7,000. The expected cash flows are $4,000, $6,000 respectively at the end of each year, and the corresponding certainty equivalent coefficient are 0.9 and 0.8. The risk-free rate of interest is 6%. The certainty equivalent of cash flow for the second year is

A. $480

B. $750

C. $4,800

D. $5,400

E. $7,500

9. Under capital rationing, the selection of a sub-set of projects from a larger number under consideration should be done using the rule where the:

A. aggregate adjusted net present values are maximized.

B. profitability index of each project is greater than 1.

C. internal rate of return on each project for the group of projects exceeds the firm's cost of capital.

D. average payback period for the group of projects exceeds the firm's target payback.

E. budget is allocated to projects which are selected on a random basis.

10. Which one of the following statements does not correctly reflect procedures that should be followed in an investment decision under capital rationing?

A. Selecting that combination of projects which has the shortest payback period.

B. Using discount rates which reflect the relative risks of projects.

C. Selecting that combination of projects which maximizes NPV.

D. Calculating incremental cash flows for each project.

E. Evaluating the timing of project implementation.