

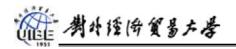
## QUIZ 2

## 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.
- 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.
- 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

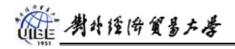


- E. Incidental effects on the remainder of the business
- An investment project requires an initial outlay of \$5m and has expected end-of-year cash inflows of \$725,000 for ten years. At the end of the project a \$500,000 salvage value is anticipated. This project has an internal rate of return of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

- iii) internal rate of return
- ii) breakeven analysis
- 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.