

Demonstration Questions for Capital Budgeting

1. Which following statement is true?
 - a. The present value of a future dollar is worth less than one dollar.
 - b. The present value of a future dollar is worth more than one dollar.
 - c. The present value of a future dollar is equal to one dollar.
 - d. The present value of a future dollar cannot be determined.

2. ABC Company has an opportunity to invest in a depreciable asset that will yield a net cash inflow of \$30,000 per year for four years. ABC's desired rate of return is 10%. Based on this information, what is the present value of the investment opportunity (round to the nearest whole dollar)?
 - a. \$31,697
 - b. \$30,000
 - c. \$95,096
 - d. \$61,069

4. Western Company can purchase an asset that costs \$1,166,900. The asset is expected to produce net cash inflows of \$300,000 per year for five years. Based on this information alone, the investment is expected to yield an internal rate of return closest to
 - a. 6%.
 - b. 9%.
 - c. 10%.
 - d. 12%.

5. The rate which equates the present value of cash inflows and outflows is the
 - a. minimum rate of return.
 - b. cost of capital.
 - c. desired rate of return.
 - d. all of the above.

Use the following information to answer the next two questions: Kramer Company paid \$60,000 to purchase a depreciable asset. The asset is expected to produce annual cash inflows of \$12,000 per year for ten years. Kramer's desired rate of return is 12%.

6. Which of the following is the present value of this investment (round to the nearest whole dollar)?
 - a. \$67,803
 - b. (\$67,803)
 - c. (\$60,000)
 - d. \$56,522

7. The internal rate of return for this investment is
 - a. equal to the desired rate of return.
 - b. greater than the desired rate of return.
 - c. less than the desired rate of return.
 - d. the answer cannot be determined from the information provided.

8. Which of the following is the approximate internal rate of return for an investment that costs \$33,900 and provides a \$6,000 annuity for 10 years?
 - a. 6%
 - b. 10%
 - c. 8%
 - d. 12%

Use the following information to answer the next two questions:

Harrison, Inc. is considering two investment opportunities. Each investment costs \$7,000 and will provide the same total future cash inflows. The schedule of estimated cash receipts for each investment follows (assume cash is received at year-end):

	Investment I	Investment II
Year 1	\$3,000	\$1,000
Year 2	2,500	2,000
Year 3	2,000	3,000
Year 4	<u>1,500</u>	<u>3,000</u>
Total	\$9,000	\$9,000

10. Which investment should Harrison choose assuming all other variables for the two investments are the same?
 - a. Harrison should be indifferent between the two investments since they provide the same total cash inflows.
 - b. Harrison should choose Investment I because of the time value of money.
 - c. Harrison should be indifferent between the two investments since the initial cash outflow is the same.
 - d. Harrison should choose Investment II because it generates larger cash inflows at the end of the investment's useful life.

11. Assuming an 8% minimum rate of return, what is the net present value of Investment II (round to the nearest whole dollar)?
 - a. \$7,227
 - b. \$227
 - c. (\$7,000)
 - d. \$926

12. KLM Company has the opportunity to purchase an asset that costs \$50,000. The asset is expected to increase net income by \$20,000 per year. The asset has a 5-year useful life. Depreciation expense used in computing net income amounted to \$10,000 per year. Based on this information the payback period is
 - a. 3.5 years.
 - b. 5 years.
 - c. 1.67 years.
 - d. 2.5 years.

13. Which of the following statements concerning payback analysis is true?
 - a. If all other variables are the same, an investment with a shorter payback period is preferable to an investment with a longer payback period.
 - b. The payback method ignores the *time value of money* concept.
 - c. The payback method and the unadjusted rate of return are different approaches that will consistently lead to the same conclusion.
 - d. a and b.