True and False Questions

1. The simple rate of return is the same as the internal rate of return.

2. If two projects require the same amount of investment, then the preference ranking computed using either the profitability index or the net present value would be the same.

3. Preference decisions attempt to determine which of many alternative investment projects would be the best for the company to accept.

4. A very useful guide for making investment decisions is: The shorter payback period, the more profitable the project.

5. The cost of capital involves blending of costs of all sources of capital funds, both debt and equity.

Multiple Choice Questions

6. Spring Company has invested $20,000 in a project. Spring’s discount rate is 12% and the profitability index on the project is 1.00. Which of the following statements would be true?

   I. The present value of the project’s net cash flows is $20,000.
   II. The project’s internal rate of return is equal to 12%.

   A) Only I.
   B) Only II.
   C) Both I and II.
   D) Neither I nor II.

7. If the internal rate of return is used as the discount rate in computing net present value, the net present value will be:

   A) positive.
   B) negative.
   C) zero.
   D) unknown.
8. The length of time required to recover the initial cash outlay for a project is determined by using:

A) discounted cash flow method.
B) the payback method.
C) the net present value method.
D) the simple rate of return method.

9. A decrease in the discount rate:

A) will increase present values of future cash flows.
B) is one way to compensate for greater risk in a project.
C) will reduce present values of future cash flows.
D) responses a and b are both correct.

10. A piece of new equipment will cost $70,000. The equipment will provide a cost savings of $15,000 per year for ten years, after which it will have a $3,000 salvage value. If the required rate of return is 14%, the equipment’s net present value is:

A) $8,240.
B) $(8,240).
C) $23,888.
D) $9,050.

11. Because Company is planning to invest in a machine with a useful life of five years and no salvage value. The machine is expected to produce cash flow from operations of $20,000 in each of the five years. Because’s required rate of return is 10%. The maximum price that the company would pay for the machine would be:

A) $32,220.
B) $62,100.
C) $75,820.
D) $122,100.

12. Bern Company is planning to invest in a two-year project that is expected to yield cash flows from operations of $50,000 in the first year and $80,000 in the second year. Bern requires a return of 14% on all investment projects. The maximum that Bern should invest in this project is:

A) $130,000.
B) $105,370.
C) $120,160.
D) $161,000.
Bates College has a telephone system that is in poor condition. The system can be either overhauled or replaced with a new system. The following data have been gathered concerning these two alternatives:

<table>
<thead>
<tr>
<th></th>
<th>Present System</th>
<th>Proposed New System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase cost when new</td>
<td>$100,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$90,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Overhaul cost needed now</td>
<td>$80,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Annual operating costs</td>
<td>$30,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Salvage value now</td>
<td>$10,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Salvage value in 8 years</td>
<td>$2,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Working capital required</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Bates College uses a 12% discount rate and the total cost approach to capital budgeting analysis. Both alternatives are expected to have a useful life of eight years.

13. The net present value of the overhaul alternative is:
   A) $(238,232).
   B) $(108,000).
   C) $(228,232).
   D) $(232,272).

14. The net present value of the new system alternative is:
   A) $(233,300).
   B) $(283,300).
   C) $(263,100).
   D) $(273,100).

Answers:

True and False

Multiple Choice