What Are Capital Budgeting Decisions?

Worksheet

Capital budgeting is the process of evaluating and selecting investment projects using methods like Net Present Value (NPV), Internal Rate of Return (IRR), and payback period to maximize shareholder value.

Questions

1. An investment has NPV of $5,000. Should it be accepted?

A) Yes, because IRR is positive
B) No, negative NPV destroys value
C) Yes, short payback period
D) Maybe, depends on company size

2. Capital budgeting primarily focuses on

A) Daily cash management
B) Long-term investment decisions
C) Monthly accounting
D) Supplier payments

3. If Project A (NPV=$30K) and Project B (NPV=$20K) cannot both be done, choose

A) Project B (lower cost)
B) Project A (higher NPV)
C) Flip a coin
D) Do neither

4. The payback period is best used as

A) Only decision method
B) A liquidity check alongside NPV/IRR
C) A replacement for NPV
D) The most important metric

5. A company considers two projects: Project A costs $100,000 with NPV of $25,000; Project B costs $100,000 with NPV of $15,000. Which should be chosen?

6. Project X has IRR of 12%, Project Y has IRR of 14%. If required return is 10%, which is better?

7. A $50,000 investment generates $10,000/year. What is the payback period?

8. Define: What is capital budgeting?

9. Define: What does NPV measure?

10. Define: When should you accept a project?

Answer Key

1. B) No, negative NPV destroys value - Negative NPV means the project destroys shareholder value. Reject it.

2. B) Long-term investment decisions - Capital budgeting evaluates significant, long-term investment projects.

3. B) Project A (higher NPV) - Choose Project A because higher NPV creates more shareholder value.

4. B) A liquidity check alongside NPV/IRR - Payback is useful for assessing risk and liquidity but shouldn't be the sole criterion.

5. Compare NPVs: Project A: NPV = $25,000 (higher) Project B: NPV = $15,000 Choose Project A because higher NPV = greater value creation

6. Both exceed the 10% required return IRR > 10% means both add value Project Y has higher IRR (14% > 12%) Project Y ranks higher

7. Payback period = Initial investment / Annual cash flow = $50,000 / $10,000 = 5 years

8. The process of evaluating and selecting long-term investment projects to maximize company value.

9. Net Present Value: the total value added by an investment after adjusting for time value of money.

10. Accept if NPV > 0, IRR > required return, or payback period is acceptable.