

Short-Answer

1. Which of the capital budgeting rules discussed in Chapter 7 fails because it ignores the time value of money?

Payback Period

2. Which of the capital budgeting rules discussed in Chapter 7 measures the “bang for your buck” – the value created per unit of resource consumed?

Profitability Index

3. Which of the capital budgeting rules discussed in Chapter 7 may fail because of multiple solutions?

Internal Rate of Return

4. Why might the internal rate of return rule fail to indicate which project has the highest net present value?

1) project may have inflows followed by outflows; 2) there may be no IRR; 3) there may be multiple IRRs; 4) IRR does not reflect the scale of the projects; 5) IRR can change if the timing of the cash flows change even if the NPV remains unchanged; 6) it is difficult to compare projects if risks differ

5. Why might the payback rule fail to indicate which project has the highest net present value?

1) ignores the time value of money, 2) ignores the project's cost of capital

Also correct: ignores cash flow after payback period; 2) no one criteria always maximizes NPV; 3) ignores scale

6. List (but do not discuss) three conditions under which the following decision rule cannot or should not be used for making capital budgeting decisions: Accept the project with the highest internal rate of return.

Three of: more than one IRR, no IRR, cash inflows followed by outflows, projects differ in size, projects have different distributions of cash flows across time, highest IRR still less than cost of capital, projects have different risk levels

Multiple-Choice

1. Which of the following capital budgeting decision rules ignores the time value of money?
- I. payback
 - II. internal rate of return
 - III. economic value added
 - IV. net present value
 - V. incremental internal rate of return
 - VI. profitability index
- a. all but IV
B. only I
c. only II and III
d. only I and VI
e. none of the rules ignore the time value of money