SNS College of Technology, Coimbatore-35.
(An Autonomous Institution)
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Second Semester
Department of Management Studies
23BAT611 - Financial Management

UNIT II

CAPITAL BUDGETING – TWO MARKS

1. What is capital budgeting?

Capital budgeting refers to the process of evaluating and selecting long-term investment projects or expenditures that involve significant amounts of funds. It involves analysing the potential cash flows and risks associated with these projects to determine their feasibility and profitability.

2. What is the payback period?

The payback period is the length of time it takes to recover the initial investment in a project or investment, usually measured in years.

3. How is the payback period calculated?

The payback period is calculated by dividing the initial investment by the annual cash inflows. It involves adding up the cash inflows until the total reaches or exceeds the initial investment.

4. What does a shorter payback period indicate?

A shorter payback period indicates that the initial investment will be recovered more quickly. It suggests a faster return on investment and a lower risk in terms of liquidity and recouping the initial outlay.

5. Methods of Capital budgeting:

Traditional method

- Payback period
- Accounting rate of return

Modern method

- Net present value
- Internal rate of return
- Profitability index

6. What is Net Present Value (NPV)?

Net Present Value (NPV) is a financial metric used in capital budgeting to determine the profitability of an investment project. It calculates the present value of expected cash inflows and outflows, taking into account the time value of money.

7.How is Net Present Value (NPV) calculated?

NPV is calculated by subtracting the initial investment (cash outflow) from the present value of expected cash inflows. The present value is calculated by discounting future cash flows using a specified discount rate.

8.What is the major difference between discounted and non-discounted method of capital budgeting?

The major difference between discounted and non-discounted methods in capital budgeting is the consideration of the time value of money. Discounted methods provide a more accurate and comprehensive evaluation by discounting cash flows to their present value, while non-discounted methods focus solely on cash flows without adjusting for the time value of money.

9. What is the Profitability Index (PI)?

The Profitability Index (PI), also known as the benefit-cost ratio, is a financial metric used in capital budgeting to assess the profitability of an investment project. It measures the relationship between the present value of expected cash inflows and the present value of cash outflows.

10.How is the Profitability Index (PI) calculated?

The Profitability Index is calculated by dividing the present value of cash inflows by the present value of cash outflows. The formula is: PI = Present Value of Cash Inflows / Present Value of Cash Outflows.

11.Define Accounting rate of return and how is it calculated

The Accounting Rate of Return (ARR) calculates the average annual accounting profit generated by an investment project as a percentage of the initial investment. It is commonly used for evaluating projects based on accounting-based metrics rather than cash flows or the time value of money.

ARR = (Average Annual Profit / Initial Investment) * 100

12. What is the acceptability based on Pay back period?

The investment with shorter payback period is accepted than longer pay back period.

13. What is the acceptability criteria of Net present Value?

If NPV greater than 0 Accept

NPV equal to 0 Consider

NPV lesser than 0 Reject

14.What is the acceptability criteria of Profitability Index?

If PI greater than 1 Accept

PI equal to 1 Consider

PI lesser than 1 Reject

15.Is a higher internal rate of return always better?

A higher internal rate of return is generally considered better, as it indicates a higher potential return on the investment. However, it is important to consider other factors such as the project's risk, the required rate of return, and the context of the

16. How does the Internal Rate of Return relate to the net present value (NPV)?

The IRR and NPV are closely related. The IRR is the discount rate at which the NPV becomes zero. If the IRR is greater than the required rate of return, the NPV will be positive, indicating a potentially profitable investment. Conversely, if the IRR is lower than the required rate of return, the NPV will be negative.

17.How is the Internal Rate of Return used in investment decision-making?

The IRR is used as a tool to assess the viability of an investment project. It helps determine whether the expected returns from the project justify the associated costs. In general, if the IRR is higher than the required rate of return or hurdle rate, the project may be considered

18.Why is Capital Budgeting important?

Capital budgeting is crucial for businesses as it helps them make informed investment decisions. By assessing potential projects and estimating their financial viability, companies can allocate their capital to projects with higher expected returns, ensuring optimal utilization of resources and maximizing shareholder wealth.

19.What are the objectives of capital budgeting?

The objectives of capital budgeting are,

- Identifying Investment Opportunities
- Allocating Capital Efficiently
- Assessing Financial Viability
- Managing Risk
- Long-term Planning and Strategy

20.What is the time value of money?

The time value of money is the concept that money available today is worth more than the same amount of money in the future, due to its potential to earn returns or interest over time.