 Capital budgeting is an important managerial activity. In this post, we'll go through the top 25 Questions and Answers-Capital Budgeting.If you read it from beginning to end, you will gain a basic understanding of capital budgeting. It will assist you in expanding your knowledge.So let's get started.Question-01: What is capital budgeting?Answer: Capital budgeting is the process of identifying, evaluating, and choosing investment projects with long-term returns.Question-02: What are the proposals or projects of capital budgeting?Answer: The proposals or projects of capital budgeting are as follows:ReplacementExpansionDiversificationResearch and DevelopmentMiscellaneousQuestion-03: What are the proposals or projects according to their relative importance?Answer: the proposals or projects according to their relative importance are as follows:Mutually Exclusive projectIndependent Single ProjectContingent ProjectCapital RationingQuestion-04: What are the policies of capital budgeting?Answer: The policies of capital budgeting are as follows:Estimating needs for investmentApproval for projects or proposalPlanning HorizonQuestion-05: What is the importance of capital budgeting?Answer: The importance of capital budgeting is as follows:Ensuring proper investmentBalancing in long term investmentAdvance plan for securing fundTimely acquisition of assets and add to fixed assetsReplacement of obsolete assetsQuestion-06: What are the limitations of Capital Budgeting?Answer: The limitations of Capital Budgeting are as follows:Lack of sufficient data for investment proposals.Lack of dependability on collected data.Problem of determining the degree of risk.Personal Influence on analysis of the analyst.Question-07: What are the elements related to capital budgeting decisions?Answer: the elements related to capital budgeting decision are as follows:Provable investment proposals.Cost of proposals or projectsCash flow of projectsProject PeriodSalvage value of the projectRisk of the projectDiscount RateMethod of evaluationQuestion-08: What is the process of capital budgeting?Answer: The process of capital budgeting is as follows:Project GenerationProject EvaluationProject SelectionProject ExecutionQuestion-09: What are the methods of evaluating capital expenditure or investment wroth?Answer: the methods of evaluating capital expenditure or investment wroth are as follows:i. Conventional Method:Payback period methodReturn on investment methodii. Discounted Cash Flow Method:Net present Value MethodInternal Rate of Return Methodiii. Profitability Indexiv. M.A.P.I. SystemQuestion-10: What is the best method for evaluating capital expenditure?Answer: Discounted cash flow method is the best method for evaluating capital expenditure.Question-11: What is the Cash payback method?Answer: The cash payback method determines the amount of time it would take to recover the cost of capital expenditure from the investment's net annual cash flow.Question-12: What are the advantages or benefits of the cash payback method?Answer: the advantages or benefits of the cash payback method are as follows:This method is very simple and easy to understand.This method measures how quickly the capital invested in the project can be repaid from the profits earned in the project so that the decision can be made considering the risk factor.Question-13: What are the disadvantages or limitations of Payback period method?Answer: the disadvantages or limitations of Payback period method are as follows:The major disadvantage of this method is that it does not place much emphasis on the earning power of the project.It doesn't consider the time value of money.Question-14: What is the annual rate of return method?Answer: Annual rate of return method determines the profitability of capital expenditure by dividing expected annual net income by the average investment.Annual Rate of Return= Expected Annual Net Income/ Average InvestmentQuestion-15: What is the cost of capital?Answer: The rate of return that management expects to receive on both borrowed and equity funds is referred to as the cost of capital.Question-16: What is discounted cash flow method?Answer: Discounted cash flow method considers both the estimated total net cash flows from the investment and the time value of money.Question-17: What is the internal rate of return (IRR)?Answer: The rate at which the present value of the proposed capital expenditure equals the present value of the estimated net annual cash flows is known as the internal rate of return (IRR).Question-18: What is the internal rate of return (IRR) method?Answer: Internal rate of return (IRR) method is the method that finds the interest yield of the potential investment.Question-19: What is the Net present value (NPV)?Answer: When the initial capital outlay is subtracted from the discounted net cash flows, the difference is known as the net present value (NPV).Question-20: What is Net present value (NPV) method?Answer: The net present value (NPV) method involves discounting net cash flows to their present value and then comparing the present value to the investment's capital outlay.Question-21: What are the advantages or benefits of Net present value (NPV) method?Answer: The advantages or benefits of Net present value (NPV) method are as follows:The investment is profitable as the net present value system considers the time value of money and converts the future earnings of the project to the present value.In this method the entire periodical income of the project is considered.This method is reasonable and reliable.Question-22: What are the disadvantages or limitations of Net present value (NPV) method?Answer: The disadvantages or limitations of Net present value (NPV) method are as follows:The use of this method is not easy for the common man. It is a bit more complicated than other methods.Many people think that determining the present value of earnings is unnecessary and difficult.Question-23: What is the required rate of return?Answer: Required rate of return is the rate that is generally based on the company's cost of capital.Question-24: What is the Profitability Index?Answer: This method calculates the present value of the project's cash flow and divides this present value by the present value of the net investment to determine the profitability index.Question-25: When is the M.A.P.I system used?Answer: This method is usually used to evaluate low capital projects and to decide on the replacement of old machines.You can also read:Top Questions and Answers:Get Top 25 Capital Budgeting Questions and Answers in PDF CA Final SFM - Capital Budgeting Notes and Questions. Students please refer to the attached document for quick to learn study notes and practice question database for CA Final SFM. Also refer to the other links for handwritten class notes and answers to the questions in the question banks.Topics Covered -- Sensitivity Analysis- Social Cost Benefit Analysis- Distinguish between NPV and IRR- Capital Rationing- Project Appraisal under inflationary conditions The 6th chapter of our finance learning course is "Capital Budgeting." In this article, we'll learn the 60 most important capital budgeting questions and their answers.It will help you quickly understand the important capital budgeting terms and their explanations.By reading this post, you may quickly prepare for "finance" courses and for any competitive tests such as school and college exams, vivas, job interviews, and so on.So let's get started…The 60 important capital budgeting questions and answers are as follows:Question 01: What is capital budgeting?Answer: Capital budgeting is the process of finding, analyzing, and choosing investment projects with returns that are expected to last longer than one year. It is the process by which a company determines whether projects like building a new plant or investing in a long-term venture are worthwhile. Ideally, companies should pursue all projects and opportunities that increase shareholder value.Question 02: What is another name for capital budgeting?Answer: Another name for capital budgeting is "investment appraisal."Question 03: What is a project?Answer: A project is a planned piece of work that has a distinct objective.Question 04: What are the types of projects?There are generally three types of projects that businesses will take on: Independent ProjectDependent ProjectMutually Exclusive ProjectQuestion 05: What are the steps in the capital budgeting process?Answer: The five steps of capital budgeting are as follows:Generating IdeasAnalyzing individual proposalsPlanning the capital budget Implementation Monitoring and follow upQuestion 06: What are the fundamental principles of capital budgeting?Answer: The following are the fundamental principles of capital budgeting: Cash flows are used to make decisions.The timing of cash flow is critical.Cash flows are calculated using opportunity costs.After-tax cash flows are examined.Financing costs (such as interest) are ignored. Sunk costs are not considered. Only incremental flows are taken into account. Inflationary effects are taken into account.Question 07: What are the objectives of capital budgeting?Answer: The following are the primary objectives of capital budgeting:Select the most profitable project for the business enterprise. Assists the business in determining the most rational project for a business venture.Aids businesses in forecasting their future revenue, cash flows, present value status of future investments, and net earnings.Demonstrate the justification for new investment and abandon older investment projects.Question 08: What are the benefits or importance of capital budgeting?Answer: The following are the benefits or importance of capital budgeting:Capital budgeting assists in selecting the best project from a pool of potential investments. Analyzing capital budgeting techniques allows an investor to forecast future cash flows.Capital budgeting allows a company to control costs and other unnecessary expenditures.Capital budgeting assists businesses in calculating the venture's future financial risks. It is cautious steeping to avoid future investment risk.It is beneficial to choose a project investment that is not frequently changed.Question 09: What are the features or characteristics of capital budgeting?Answer: The following are the five most important features or characteristics of capital budgeting:Cash flows are used to make capital budgeting decisions.The timing of cash flows is critical in capital budgeting decisions. Cash flows are calculated using opportunity costs.Capital budgeting ignores financing and sunk costs.The cash flows are examined after taxes.Question 10: What are the constraints or limitations of capital budgeting?Answer: The top five constraints of capital budgeting are as follows:Because major project decisions are based on forecasting, there is a chance that important project information will be overlooked.This budgeting technique does not allow for the estimation of probable future risk.Sometimes a country's economic turmoil can have an impact on capital budgeting decisions for a future project.Estimating the economic life of an investment is perhaps the most difficult task.There are numerous unknown factors that cannot be predicted and cannot be controlled or avoided.Question 11: What is the application of capital budgeting?Answer: Capital budgeting is used in all aspects of long-term investment decisions. The following are some examples of popular capital budgeting applications:Purchase of a fixed asset.Business expansion with the goal of increasing production capacity.Product differentiationModernization and replacement.Question 12: What are the factors affecting capital budgeting decisions?Answer: The following factors influence capital budgeting decisions:Maturity of Project RiskCost Cash flowsPresent value factorQuestion 13: What are the major cash flow components?Answer: The following are the major cash flow components:Initial cash outflowInterim Incremental Net Cash FlowsTerminal Year Incremental Net Cash FlowQuestion 14: What is an initial cash outflow?Answer: The amount of money paid out or received at the start of a project or investment is referred to as the "initial cash outflow."Question 15: How do you calculate the initial cash outflow?Answer: The initial cash flow is calculated in the following manner:Initial cash flow = cost of the new asset – capitalized expenditures +/- increased or decreased level of net working capital +/- net proceeds from the sale of old assets +/- taxes (tax savings) from the sale of old assetsQuestion 16: What are the interim incremental net cash flows?Answer: Interim incremental net cash flows are the extra operating cash flows that a company gets because it started a new project.Question 17: How do you calculate the interim incremental net cash flows?Answer: The interim incremental net cash flows are calculated as follows:Incremental Net Cash Flow for the Period = Net increase (decrease) in operating revenue -/+ any net increase or decrease in operating expenses, excluding depreciation +/- Net increase or decrease in tax depreciation charges +/- Net increase or decrease in taxes +/- Net increase or decrease in tax depreciation chargesQuestion 18: How do you calculate the terminal-year incremental net cash flow?Answer: The terminal year incremental net cash flow is calculated as follows:Terminal year incremental net cash flow = Net increase or decrease in operating revenue -/+ any net increase or decrease in operating expenses, excluding depreciation +/- Net increase or decrease in tax depreciation charges +/- Net increase or decrease in taxes +/- Net increase or decrease in tax depreciation charges +/- initial salvage value of new assets -/+ Taxes or Tax savings due to sale or disposal of new assets +/- decreased or increased level of net working capitalQuestion 19: What are the types of capital budgeting decisions?Answer: The following are the different types of capital budgeting decisions: Accept or reject decisionMutually exclusive decisionCapital rationing decisionRanking methodNon-discounted methods of capital budgetingDiscounted methods of capital budgetingQuestion 20: What is an "accept or reject" decision?Answer: This is an important decision in capital budgeting. The farm would invest in the project if it were accepted, but not if it were rejected. Most project proposals are accepted if their rates of return are higher than a certain minimum rate of return. Under the accept or reject decision, all separate products that meet the minimum investment criteria should be put into place.Question 21: What are mutually exclusive decisions?Answer: Projects that compete with each other but don't affect each other's chances of getting approved are said to be "mutually exclusive." Only one of the options is allowable because they are mutually exclusive.Question 22: What is a capital rationing decision?Answer: If the business has no limits on how much money it can spend, any independent investment proposal with a return higher than a certain level could be accepted.In reality, a business's budget for project implementation is limited. There are many investment proposals competing for those limited funds. As a result, the business must ration them. The business allocates funds to projects in such a way that long-term returns are maximized. Capital rationing is a term for a business's financial situation in which it only has a small amount of money to spend on capital investments.Question 23: What is the ranking method?Answer: Using different capital budgeting techniques, this method starts by figuring out how likely each project is to happen. The project with the highest return is then ranked first, followed by the project with the lowest return. The project with the highest ranking is chosen, and the investment decision is made.Question 24: What are the non-discounted methods of capital budgeting?Answer: The non-discounted methods of capital budgeting are as follows:Payback Period (PBP)Average Rate of Return (ARR)Pay Back Reciprocal (PBR)Question 25: What are the discounted methods of capital budgeting?Answer: The discounted methods of capital budgeting are as follows:Net Present Value (NPV)Internal Rate of Return (IRR)Profitability Index (PI)Modified Internal Rate of Return (MIRR)Discounted Pay Back Period (DPBP)Question 26: What is a payback period (PBP)?Answer: The payback period is the number of years it takes to get back the money you put into a project at the beginning.The payback period is one of the most common and widely accepted ways to judge investment proposals. The PBP figures out how long it will take to get back the initial cash investment based on the expected cash flows.Question 27: What is the average rate of return (ARR)?Answer: When you divide the average annual net income after taxes by the average investment, you get the average rate of return. It considers both the amount invested and the profit generated. Question 28: What is the net present value (VPV)?Answer: The net present value of a project is the sum of the present values of all expected future cash flows over the project's life, less the initial cash outlay.The net present value is the traditional economic method for assessing investment proposals. It is one of the most important ways to discount money that takes into account the value of time. It makes the right assumption that future cash flows from different time periods have different values and can't be compared until their equivalent present values are known.Question 29: What is an internal rate of return (IRR)?Answer: Another method for discounting is the internal rate of return. A project's IRR is the discount rate that equals its NPV.It is the discount rate at which the present value of future cash flows is equal to the initial investment.Question 30: What is a profitability index (PI)?Answer: The profitability index is the ratio you get when you divide the present value of all future cash inflows by the present value of all cash outflows.Question 31: What are the techniques or methods of capital budgeting?Answer: The following are capital budgeting techniques or methods:Net Present Value (NPV)Internal Rate of Return (IRR)Payback Period (PBP)Discounted Payback Period (DPBP)Average Rate of Return (ARR)Profitability Index (PI)Question 32: What is the formula for NPV, and how do you calculate NPV?Answer: The formula for calculating NPV is as follows:Here,CFt = After-tax cash flow at time tR = Required rate of return for the investmentOutlay = Initial cash outflow or investment Calculation:Let's calculate the net present value (NPV) using a straightforward example.ABC Corporation is thinking about investing $30,000 in a project that will generate after-tax cash flows of $12,000 per year for the next three years and an additional $20,000 in the fourth year. The required rate of return is 13%.The NPV for ABC Corporation would be as follows, using the above formula:NPV= 12/1.13+12/(1.13)+12/1.13+20/1.13-30 =10.62+9.4+8.32+12.27-30 =40.61-30 =10.61Since the NPV is positive, the investment will therefore be accepted.Question 33: What are the NPV decision criteria?Answer: The following are the NPV decision criteria:Invest: If the NPV is greater than or equal to zero.Do not make an investment: If the NPV is less than zero.Question 34: What are the benefits of using the Net Present Value (NPV) method?Answer: The net present value (NPV) method has the following benefits:It recognizes the time value of money.It calculates the project's worth based on all cash flows that occur over the course of the project's life.The discounting process allows you to calculate cash flows in terms of present value.The NPV Method can be modified to account for risk.It took into account the risk of future cash flows (through the cost of capital).The NPV method is always in line with the goal of maximizing shareholder wealth.Question 35: What are the disadvantages of using the Net Present Value (NPV) method?Answer: The following are the disadvantages of the net present value (NPV) method:In comparison to PBP or ARR, it is difficult to understand, calculate, and use. The problem associated with NPVs involves calculating the required rate of return or cost of capital to discount the cash flows.When comparing alternative projects with unequal life, use caution when using the NPV.Question 36: What is the formula for IRR?Answer: The internal rate of return (IRR) formula is: IRR = r = the discount rate that makes the net present value of the investment equal to zero.Question 37: What are the IRR decision criteria?Answer: The IRR decision criteria are as follows:Invest: If the IRR is greater than or equal to the required rate of return.Don't invest: If the IRR is less than the required rate of return.Question 38: What are the benefits of using the Internal Rate of Return (IRR) method?Answer: The following are the benefits of using the Internal Rate of Return (IRR) method:It takes into account the time value of money.It considers total cash inflows and outflows.For business executives, the IRR is simpler to grasp.It is consistent with the overall goal of increasing shareholder wealth.It takes into account the risks associated with future cash flows.Question 39: What are the disadvantages of using the Internal Rate of Return (IRR) method?Answer: The following are the disadvantages of the Internal Rate of Return (IRR) method:It entails arduous and time-consuming calculations.It may generate multiple rates, which can be perplexing.IRR does not account for scale or amount.If the project has a long duration, the trial and error process used to calculate the IRR can become unmanageable.Question 40: What is the PBP formula?Answer: The following is the formula for calculating the payback period (PBP):PBP= a+((ICO-c)/d)Here,a= the year of the cumulative inflow closest to the year of the initial cash outflowICO= Initial Cash Outlayc=Cumulative inflow of a yeard= Inflow of the year of recoveryQuestion 41: What are the PBP decision criteria?Answer: The payback period decision criteria are as follows:The proposal is accepted if the calculated payback period is less than some maximum acceptable payback period.The project is rejected if the payback period exceeds the acceptable payback period.Question 42: What are the benefits of using the Pay Back Period (PBP) method?Answer: The Pay Back Period (PBP) method has the following benefits:It is very simple to compute.The method provides some information about the investment's risks. When the payback period exceeds an acceptable payback period, the project becomes more uncertain.This method does not provide a rough estimate of the project's liquidity.Question 43: What are the disadvantages of using the Payback Period (PBP) method?Answer: The Payback Period (PBP) method has the following disadvantages:There are no concrete decision criteria for determining whether an investment increases the firm's value.The method disregards cash flows that occur after the payback period.It ignores the concept of the time value of money.It also takes no account of the risk of future cash flows.This method is an ineffective predictor of profitability.Question 44: What is the Discounted Pay Back Period (DPBP) formula?Answer: The following is the formula for calculating the discounted payback period (DPBP):DPBP= a+((ICO-c)/d)Here,a= the year of the cumulative inflow closest to the year of the initial cash outflowICO= Initial Cash Outlayc=Cumulative inflow of a yeard= Inflow of the year of recoveryQuestion 45: What are the benefits of the Discounted Pay Back Period (DPBP) method?Answer: The following are the benefits of the discounted payback period (DPBP) method:The primary benefit of a discounted payback period is that it takes into account the time value of money.It also takes into account the riskiness of the project's cash flows (through the cost of capital).Question 46: What are the disadvantages of using the Discounted Payback Period (DPBP) method?Answer: The following are the disadvantages of the Discounted Pay Back Period (DPBP) method:This method, like the payback period method, ignores cash flows after the discounted payback period is reached.This method is still not a reliable indicator of profitability.There are no concrete decision criteria for determining whether an investment increases the firm's value.The maximum acceptable discounted payback period is entirely arbitrary.Question 47: What is the formula of an average or accounting rate of return (ARR)?Answer: The formula for figuring out an average or accounting rate of return (ARR) is as follows:ARR= Average net income/Average InvestmentHere,Average Investment=(Initial Investment +Salvage Value)/2Question 48: What are the ARR decision criteria?Answer: The following are the ARR decision criteria:Accept: If the actual ARR exceeds or equals the projected ARR.Don't accept: If the actual ARR is less than or equal to the projected ARR.Question 49: What are the benefits of calculating the average rate of return (ARR)?Answer: The following are the benefits of using the Average Rate of Return (ARR) method:It is simple to comprehend, calculate, and apply.The ARR method is easy to figure out from accounting data, and unlike the NPV and IRR methods, it doesn't require any adjustments to get to the cash flows of the project.It considers benefits over the project's entire life cycle.The ARR rule considers the entire income stream when calculating the project's profitability.Question 50: What are the disadvantages of using the Average Rate of Return (ARR) method?Answer: The following are the disadvantages of the Average Rate of Return (ARR) method:It is calculated using accounting profit rather than cash flow.It does not account for the time value of money.The ARR does not account for any benefits that may accrue after the project is completed.The ARR makes no distinction between the sizes of the investments needed for each project.Question 51: What is the PI formula, and how is it calculated?Answer: The following is the formula for calculating PI:PI = PV of future cash flows/Initial investmentOrPI= 1+(NPV/Initial Investment)Calculation:The example below will show you how to calculate the Profitability Index (PI).Assume ABC Corporation is considering a $42,000 investment in a capital project that will generate after-tax cash flows of $14,000 per year for the next five years. The cost of capital is 10%.The estimated present value of future cash flows is $53,071.Here,PV of Future cash flows=$53,071Initial Investment = $42,000PI=?Profitability Index (PI)= (53,071/42000)= 1.26Question 52: What are the PI Decision Criteria?Answer: The following are the PI decision criteria:If PI is greater than or equal to one, invest.If the PI is less than one, do not invest.Question 53: What are the advantages of the Profitability Index (PI) method?Answer: In capital budgeting decision-making, the Profitability Index has the following advantages:The PI meets almost all of the criteria for a sound investment.It takes into account the time value of money.It assesses all of the project's cash flows.It indicates whether or not an investment increases the firm's value.Question 54: What are the disadvantages of using the Profitability Index (PI) method?Answer: The following are the Profitability Index's disadvantages:The calculation necessitates an estimate of the capital cost.When used to compare mutually exclusive projects, it may not provide the correct decision.Question 55: What is the difference between capital budgeting and capital rationing?Answer: The three important differences between capital budgeting and capital rationing are as follows:Capital budgeting is the process of generating, analyzing, and allocating long-term investments to the capital budget. "Capital rationing," on the other hand, is a situation in which the amount of funding available is limited to the point where projects cannot be accepted.Capital budgeting functions include project evaluation, selection, and implementation. On the other hand, the goal of capital rationing is to choose projects that will make the most money out of the limited amount of money.To analyze projects, capital budgeting is used. Capital rationing, on the other hand, is used to accept or reject projects.Question 56: What is the distinction between Net Present Value (NPV) and Internal Rate of Return (IRR)?Answer: The following are the three important distinctions between the net present value (NPV) and the internal rate of return (IRR):NPV is the present value of future cash flows discounted at the required rate of return minus the project's initial investment. Whereas IRR is the rate of return that equates the present value of a series of cash inflows with the initial investment.The NPV method's goal is to compute the net value. The goal of the IRR method is to calculate the required rate.The project is profitable if the NPV is positive. The project is profitable if the IRR is greater than the cost of capital.Question 57: What is the distinction between Net Present Value (NPV) and Profitability Index (PI)?Answer: The following are the three important distinctions between net present value (NPV) and profitability index (PI):NPV is the present value of future cash flows discounted at the required rate of return minus the project's initial investment. Whereas PI is the present value of future cash flows discounted at the required rate of return divided by the project's initial investment.The NPV method's goal is to compute the net value. The goal of the PI method is to calculate the ratio.The project is profitable if the NPV is positive. The project is profitable if the PI is greater than one.Question 58: Which technique, NPV or IRR, is preferred and why?Answer: It is difficult to choose between approaches. It is smart to look at NPV and IRR methods from both a theoretical and a practical point of view.The theoretical point of view: Answer: NPV is the superior approach to capital budgeting for the following reasons:The NPV user assumes that any intermediate cash inflows from an investment are reinvested at the firm's cost of capital. whereas the use of IRR assumes that the IRR will reinvest any of these cash inflows. The cost of capital, on the other hand, is the realistic investment rate.A project with an unusual cash flow may produce multiple IRR, whereas NPV does not have this issue.The practical point of view: Answer: Even though the NPV method is better in theory, financial managers prefer the IRR method for the following reasons:Rates of return are preferred by businesspeople over dollar returns. In this regard, IRR is preferable.NPV is less intuitive to financial decision-makers because it does not measure benefits in relation to the amount invested.There are several methods for avoiding the difficulty of the IRR.Question 59: When is the profitability index better than the NPV?Answer: In the following situations, it is thought that the profitability index is better than the net present value (NPV).In terms of capital rationing decisions, the profitability index is thought to be better than the NPV.If the initial investment is unequal and I am asked to accept or reject a decision, the profitability index will be a better technique than the NPV.In the profitability index method, the net present value of the cash flows is calculated first, followed by the profitability index. As a result, the profitability index becomes preferable.Question 60: What is the best way to figure out how much a capital expenditure or investment is worth?Answer: There are two types of capital budgeting methods: traditional and discounted cash flow. The discounted cash flow method is the better option of the two.I hope that by the end of this post, you will have a good understanding of the "capital budgeting" chapter.You will gain a better understanding of the "capital budgeting" chapter if you read these "60 important capital budgeting questions and answers" on a regular basis.You can read the first five chapters of our finance learning course here: