UNIT 3

Capital Budgeting : Meaning, Need, Nature & Objectives, Kinds of Capital Budgeting Decisions, Methods of evaluation of capital budgeting – Traditional & Discounted Methods Dividend Policies – Concept, Types, Models of Dividend Policies- Walter, Gordon & Modgliani & Miller

❖ MULTIPLE CHOICE QUESTION

Q1. What is capital budgeting?

- **A)** Short-term financial planning
- **B)** Long-term financial planning
- **C)** Managing day-to-day expenses
- **D)** Budgeting for marketing activities

Answer: B) Long-term financial planning

Q2. Which of the following is not a reason for the need of capital budgeting?

- **A)** Maximizing shareholder wealth
- **B)** Allocating scarce resources efficiently
- **C)** Planning for long-term investments
- **D)** Managing day-to-day expenses

Answer: D) Managing day-to-day expenses

Q3. What is the nature of capital budgeting decisions?

- **A)** Short-term
- **B)** Dynamic
- **C)** Tactical
- **D)** Operational

Answer: B) Dynamic

Q4. Which of the following is not an objective of capital budgeting?

- **A)** Maximizing profitability
- **B)** Minimizing risk
- **C)** Enhancing market share
- **D)** **Increasing shareholder wealth**

Answer: C) Enhancing market share

Q5. What are the kinds of capital budgeting decisions?

- **A)** Short-term and long-term
- **B)** Profit-maximizing and wealth-maximizing
- **C)** Strategic and tactical
- **D)** Investment and financing

Answer: A) Short-term and long-term

Q6. Which of the following is a traditional method of capital budgeting?

- **A)** Payback period
- **B)** Net Present Value (NPV)
- **C)** Internal Rate of Return (IRR)
- **D)** Profitability Index (PI)

Answer: A) Payback period

Q7. Which method of capital budgeting accounts for the time value of money?

- **A)** Accounting Rate of Return (ARR)
- **B)** Payback period
- **C)** Net Present Value (NPV)
- **D)** Profitability Index (PI)

Answer: C) Net Present Value (NPV)

Q8. Which method of evaluation of capital budgeting considers the entire cash flows over the project's life?

- **A)** Internal Rate of Return (IRR)
- **B)** Payback period
- **C)** Net Present Value (NPV)
- **D)** Profitability Index (PI)

Answer: C) Net Present Value (NPV)

Q9. The internal rate of return (IRR) is the discount rate that makes which of the following equal to zero?

- **A)** Net Present Value (NPV)
- **B)** Payback period
- **C)** Accounting Rate of Return (ARR)
- **D)** Profitability Index (PI)

Answer: A) Net Present Value (NPV)

Q10. Which method of capital budgeting ignores cash flows beyond the payback period?

- **A)** Net Present Value (NPV)
- **B)** Internal Rate of Return (IRR)
- **C)** Payback period
- **D)** Profitability Index (PI)

Answer: C) Payback period

Q11. What is dividend policy?

- **A)** Policy of taking loans for business operations
- **B)** Policy of distributing profits to shareholders
- **C)** Policy of acquiring other companies

- **D)** Policy of issuing new shares

Answer: B) Policy of distributing profits to shareholders

Q12. Which of the following is not a type of dividend policy?

- **A)** Stable dividend policy
- **B)** Irregular dividend policy
- **C)** Zero dividend policy
- **D)** Variable dividend policy

Answer: C) Zero dividend policy

Q13. The Walter model of dividend policy suggests that dividend policy affects which of the following?

- **A)** Stock price
- **B)** Firm's investment decisions
- **C)** Risk appetite of shareholders
- **D)** Dividend payout ratio

Answer: A) Stock price

Q14. According to the Gordon model, the value of a firm is directly related to which of the following?

- **A)** Dividend payout ratio
- **B)** Retained earnings
- **C)** Dividend yield
- **D)** Dividend per share

Answer: D) Dividend per share

Q15. Which model of dividend policy considers the relevance of the dividend in a world without taxes and uncertainty?

- **A)** Modigliani & Miller model
- **B)** Gordon model
- **C)** Walter model
- **D)** Residual dividend model

Answer: A) Modigliani & Miller model

Q16. Which of the following dividend policies offers a fixed amount of dividends regardless of earnings?

- **A)** Stable dividend policy
- **B)** Constant dividend policy
- **C)** Regular dividend policy
- **D)** Irregular dividend policy

Answer: A) Stable dividend policy

Q17. The Modigliani & Miller model assumes which of the following?

- **A)** Investors prefer dividends over capital gains
- **B)** Taxes and uncertainty do not exist
- **C)** Retained earnings have no value
- **D)** Dividends increase the firm's value

Answer: B) Taxes and uncertainty do not exist

Q18. What does the Walter model focus on?
- **A)** Impact of dividend policy on stock price
- **B)** Effect of dividends on capital structure
- **C)** Relationship between dividends and earnings
- **D)** Optimal dividend payout ratio

Answer: A) Impact of dividend policy on stock price

Q19. According to the Gordon model, the value of a firm is inversely related to which of the following?
- **A)** Dividend payout ratio
- **B)** Dividend per share
- **C)** Earnings per share
- **D)** Retained earnings

Answer: A) Dividend payout ratio

Q20. What does the Modigliani & Miller model suggest about dividend policy in a world without taxes and uncertainty?
- **A)** Dividend policy is irrelevant
- **B)** Stable dividend policy is optimal
- **C)** Constant growth dividend policy is optimal
- **D)** High dividend payout ratio is optimal

Answer: A) Dividend policy is irrelevant

Q21. Which of the following dividend policies is most suitable for mature and stable companies?
- **A)** Stable dividend policy
- **B)** Constant dividend policy
- **C)** Residual dividend policy
- **D)** Target payout ratio policy

Answer: A) Stable dividend policy

Q22. In the Walter model, if the rate of return exceeds the internal rate of return (r > I), the firm should adopt which dividend policy?
- **A)** Retain all earnings
- **B)** Pay out all earnings
- **C)** Maintain a constant dividend payout ratio
- **D)** Follow a zero dividend policy

Answer: B) Pay out all earnings

Q23. The Gordon model is also known as the:
- **A)** Dividend Discount Model
- **B)** Capital Asset Pricing Model
- **C)** Arbitrage Pricing Theory
- **D)** Black-Scholes Model

Answer: A) Dividend Discount Model

Q24. Which of the following dividend policies suggests paying dividends out of residual earnings after meeting investment needs?
- **A)** Stable dividend policy

B) Constant dividend policy
C) Residual dividend policy
D) Target payout ratio policy

Answer: C) Residual dividend policy

Q25. Which of the following is not a factor influencing dividend policy decisions?

A) Earnings Stability
B) Legal Constraints
C) Market Conditions
D) Dividend Tax Rate

Answer: D) Dividend Tax Rate

Q26. The irrelevance theory of dividends suggests that:

A) Dividends are irrelevant for the firm's value.
B) Investors prefer higher dividends.
C) Retained earnings increase firm value.
D) Dividends reduce the cost of equity.

Answer: A) Dividends are irrelevant for the firm's value.

Q27. Which dividend policy aims to pay a fixed percentage of earnings as dividends?

A) Stable Dividend Policy
B) Constant Dividend Policy
C) Residual Dividend Policy
D) Target Payout Ratio Policy

Answer: D) Target Payout Ratio Policy

Q28. Which model of dividend policy emphasizes the impact of dividends on the firm's investment opportunities?

A) Gordon Model
B) Modigliani & Miller Model
C) Walter Model
D) Dividend Discount Model

Answer: C) Walter Model

Q29. Which dividend policy suggests paying dividends based on leftover earnings after funding all capital projects?

A) Stable Dividend Policy
B) Constant Dividend Policy
C) Residual Dividend Policy
D) Target Payout Ratio Policy

Answer: C) Residual Dividend Policy

Q30. What does the Residual Dividend Policy prioritize?

A) Stable dividend payments
B) Financing new projects
C) Maximizing shareholder wealth
D) Increasing retained earnings

Answer: B) Financing new projects

Q31. The Modigliani & Miller model assumes which of the following about investors?

- **A)** They prefer high dividends.
- **B)** They are indifferent between dividends and capital gains.
- **C)** They focus on short-term profits.
- **D)** They prefer companies with low dividend payouts.

Answer: B) They are indifferent between dividends and capital gains.

Q32. Which model suggests that dividend policy is determined by the firm's ability to earn a return greater than the cost of equity?

- **A)** Gordon Model
- **B)** Modigliani & Miller Model
- **C)** Walter Model
- **D)** Dividend Discount Model

Answer: C) Walter Model

Q33. Which type of dividend policy is more suitable for high-growth firms?

- **A)** Stable Dividend Policy
- **B)** Constant Dividend Policy
- **C)** Residual Dividend Policy
- **D)** Target Payout Ratio Policy

Answer: C) Residual Dividend Policy

Q34. What is the primary focus of the Gordon Model?

- **A)** Dividend stability
- **B)** Maximizing dividends
- **C)** Firm valuation
- **D)** Retained earnings

Answer: C) Firm valuation

Q35. According to the Dividend Irrelevance Theory, which factor does not affect the value of the firm?

- **A)** Dividend policy
- **B)** Earnings per share
- **C)** Cost of capital
- **D)** Investment opportunities

Answer: A) Dividend policy

Q36. Which dividend policy is often associated with minimizing the firm's cost of equity?

- **A)** Stable Dividend Policy
- **B)** Constant Dividend Policy
- **C)** Residual Dividend Policy
- **D)** Target Payout Ratio Policy

Answer: C) Residual Dividend Policy

Q37. Which model suggests that investors can create their own desired dividend payout by selling shares?

- **A)** Gordon Model
- **B)** Modigliani & Miller Model
- **C)** Walter Model

D) Dividend Discount Model

Answer: B) Modigliani & Miller Model

Q38. Which dividend policy is likely to provide the most stable income for shareholders?

A) Stable Dividend Policy
B) Constant Dividend Policy
C) Residual Dividend Policy
D) Target Payout Ratio Policy

Answer: A) Stable Dividend Policy

Q39. What does the Gordon Model use to estimate the value of a firm's stock?

A) Dividend yield
B) Dividend per share
C) Retained earnings
D) Dividend payout ratio

Answer: B) Dividend per share

Q40. What does Capital Budgeting refer to?

A) Short-term financial planning
B) Long-term financial planning
C) Day-to-day financial management
D) None of the above

Answer: B) Long-term financial planning

Q41. Which of the following is a need for Capital Budgeting?

A) Assessing daily expenses
B) Identifying long-term investment opportunities
C) Monitoring monthly revenue
D) None of the above

Answer: B) Identifying long-term investment opportunities

Q42. What is the nature of Capital Budgeting decisions?

A) Short-term
B) Medium-term
C) Long-term
D) Immediate

Answer: C) Long-term

Q43. Which of the following is NOT an objective of Capital Budgeting?

A) Maximizing shareholder wealth
B) Minimizing financial risk
C) Enhancing short-term profits
D) Selecting profitable projects

Answer: C) Enhancing short-term profits

Q44. Which of the following is NOT a type of Capital Budgeting decision?

A) Replacement decisions
B) Expansion decisions
C) Revenue decisions
D) Diversification decisions

Answer: C) Revenue decisions

Q45. What are the methods used for the evaluation of Capital Budgeting?

- **A)** Traditional methods
- **B)** Discounted methods
- **C)** Both A and B
- **D)** None of the above

Answer: C) Both A and B

Q46. Which of the following is a traditional method of capital budgeting?

- **A)** Payback period
- **B)** Net Present Value (NPV)
- **C)** Internal Rate of Return (IRR)
- **D)** Profitability Index (PI)

Answer: A) Payback period

Q47. Which method of evaluation of Capital Budgeting considers the time value of money?

- **A)** Payback period
- **B)** Accounting Rate of Return (ARR)
- **C)** Net Present Value (NPV)
- **D)** Payback Discounted (PBDD)

Answer: C) Net Present Value (NPV)

Q48. What is the concept of Dividend Policies?

- **A)** Managing short-term investments
- **B)** Distributing profits to shareholders
- **C)** Reducing long-term liabilities
- **D)** None of the above

Answer: B) Distributing profits to shareholders

Q49. Which of the following is NOT a type of Dividend Policy?

- **A)** Stable Dividend Policy
- **B)** Residual Dividend Policy
- **C)** Aggressive Dividend Policy
- **D)** Growth Dividend Policy

Answer: D) Growth Dividend Policy

Q50. Which model of Dividend Policy focuses on the relationship between dividends and the firm's cost of equity?

- **A)** Walter Model
- **B)** Gordon Model
- **C)** Modigliani & Miller Model
- **D)** Lintner Model

Answer: B) Gordon Model

Q51. Which Dividend Policy model assumes that there is no external financing?

- **A)** Walter Model
- **B)** Gordon Model
- **C)** Modigliani & Miller Model
- **D)** Lintner Model

Answer: A) Walter Model

Q52. Which of the following is NOT a component of the Modigliani & Miller Dividend Irrelevance Theory?

- **A)** Dividend payout ratio
- **B)** Capital gains
- **C)** Tax considerations
- **D)** Investor preferences

Answer: A) Dividend payout ratio

Q53. Which of the following is a limitation of the Payback Period method?

- **A)** It considers the time value of money
- **B)** It ignores cash flows beyond the payback period
- **C)** It is complex to calculate
- **D)** It doesn't consider profitability

Answer: B) It ignores cash flows beyond the payback period

Q54. What does the NPV method consider in evaluating investment projects?

- **A)** Only cash inflows
- **B)** Only cash outflows
- **C)** Both cash inflows and outflows
- **D)** Only accounting profits

Answer: C) Both cash inflows and outflows

Q55. In Capital Budgeting, the IRR is the discount rate at which:

- **A)** NPV is equal to zero
- **B)** NPV is maximum
- **C)** Payback period is minimum
- **D)** ARR is highest

Answer: A) NPV is equal to zero

Q56. Which of the following statements about the Payback Period is true?

- **A)** It considers the time value of money
- **B)** It is a measure of profitability
- **C)** It is calculated as the time taken to recover initial investment
- **D)** It is suitable for evaluating projects with uneven cash flows

Answer: C) It is calculated as the time taken to recover initial investment

Q57. Which of the following is NOT a discounted method of evaluating capital budgeting projects?

- **A)** NPV
- **B)** IRR
- **C)** ARR
- **D)** PI

Answer: C) ARR

Q58. Which Dividend Policy model suggests that dividends are relevant and influence the value of the firm?

- **A)** Walter Model
- **B)** Gordon Model

C) Modigliani & Miller Model
D) Lintner Model

Answer: A) Walter Model

Q59. Which of the following is NOT a consideration in determining the optimal dividend policy according to the Modigliani & Miller model?

A) Taxes
B) Transaction costs
C) Cost of equity
D) Market value of assets

Answer: B) Transaction costs

Q60. Which method of capital budgeting evaluation considers the time value of money and is considered the most accurate?

A) Payback Period
B) Net Present Value (NPV)
C) Internal Rate of Return (IRR)
D) Profitability Index (PI)

Answer: B) Net Present Value (NPV)

Q61. In Capital Budgeting, which method helps in ranking projects by considering the present value of cash flows?

A) Payback Period
B) Accounting Rate of Return (ARR)
C) Net Present Value (NPV)
D) Internal Rate of Return (IRR)

Answer: C) Net Present Value (NPV)

Q62. Which Dividend Policy model suggests that dividends do not affect the firm's value and are irrelevant?

A) Walter Model
B) Gordon Model
C) Modigliani & Miller Model
D) Lintner Model

Answer: C) Modigliani & Miller Model

Q63. What is the primary focus of Capital Budgeting decisions?

A) Short-term profitability
B) Long-term investment opportunities
C) Daily operational costs
D) Immediate revenue generation

Answer: B) Long-term investment opportunities

Q64. What is the primary objective of capital budgeting?

a) Maximizing shareholder wealth
b) Minimizing costs
c) Maximizing revenue
d) Achieving market dominance

Answer: a) Maximizing shareholder wealth

Q65. Which of the following is NOT a traditional method of evaluation in capital budgeting?

a) Payback period
b) Net present value (NPV)
c) Internal rate of return (IRR)
d) Earnings per share (EPS)

Answer: d) Earnings per share (EPS)

Q66. Which of the following capital budgeting methods accounts for the time value of money?

a) Payback period
b) Accounting rate of return (ARR)
c) Net present value (NPV)
d) Profitability index (PI)

Answer: c) Net present value (NPV)

Q67. Which type of dividend policy maintains a relatively stable dividend payout ratio over time?

a) Constant dividend payout ratio
b) Residual dividend payout ratio
c) Regular dividend payout ratio
d) Special dividend payout ratio

Answer: a) Constant dividend payout ratio

Q68. The Walter model of dividend policy focuses on:

a) Market expectations
b) Retained earnings
c) Dividend irrelevance
d) Cost of equity

Answer: b) Retained earnings

Q69. Which dividend policy model suggests that dividend policy is irrelevant to the value of the firm?

a) Gordon model
b) Walter model
c) Modigliani-Miller model
d) Dividend stability model

Answer: c) Modigliani-Miller model

Q70. Which of the following is NOT a type of capital budgeting decision?

a) Replacement decisions
b) Expansion decisions
c) Financing decisions
d) Strategic decisions

Answer: c) Financing decisions

Q71. Which capital budgeting method is based on accounting profits rather than cash flows?

a) Internal rate of return (IRR)
b) Payback period

c) Accounting rate of return (ARR)
d) Net present value (NPV)
Answer: c) Accounting rate of return (ARR)

Q72. Which dividend policy model suggests that the dividend payout ratio is directly related to the firm's internal rate of return?
a) Walter model
b) Modigliani-Miller model
c) Gordon model
d) Bird-in-the-hand theory
Answer: c) Gordon model

Q73. What is the main objective of evaluating capital budgeting decisions using the discounted cash flow (DCF) methods?
a) To account for inflation
b) To incorporate risk
c) To consider the time value of money
d) To calculate accounting profits
Answer: c) To consider the time value of money