#1-177A

EASY INTERMEDIATE HARD

CFA® SAMPLE QUESTION – LEVEL I

Corporate Finance

Q: As a corporate finance manager, you are evaluating two mutually exclusive projects of the same risk class, Project A and Project B.

Both will have the same initial cash outflow and both have positive NPVs.

Which of the following is the reason to choose Project A instead of Project B.

CORRECT ANSWER:

Ⓒ Project B has a lower profitability index than Project A.

Please remember that the correct method of choosing between two "mutually exclusive" projects is to choose the one with the higher NPV.

$$PI = \frac{\sum_{t=0}^{n} \frac{CF_t}{(1+r)^t}}{I}$$

The Profitability index is calculated as the present value of the future cash flow divided by the initial outlay for the project.

Given that both projects have the same initial cash outflow, that mean the one with higher profitability index will have the higher present value of future cash flows and thus higher NPV.

Ranking projects on their payback periods or their accounting rates of return can lead to incorrect ranking.

CFA Society Hong Kong Candidate Services

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