Question #1 of 34

Question ID: 1209541

The present value of expected future cash flows is the firm's:

A) going-concern value.

B) liquidation value.

C) terminal value.

Explanation

Going-concern value is the present worth of expected future cash flows generated by a business.

(Study Session 9, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 3

Question #2 of 34

Question ID: 1209563

A valuation of a firm based on the comparison of the firm with the market value of other firms is known as a:

A) relative valuation.

B) comparison valuation.

C) peer group valuation.

Explanation

A relative valuation is a valuation based on comparing the firm to other firms with similar characteristics. Market multiples are commonly used as the basis of relative valuations.

(Study Session 9, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 3

Question #3 of 34

Question ID: 1209539

A comparison between a firm's going-concern valuation and its liquidation value will show that the going-concern value will always be:

A) equal to the present value of the expected continued operation of the firm. ✓

B) less than the liquidation value. ✗

C) greater than the liquidation value. ✗

Explanation

It is not possible to state the relationship between the going-concern value and the liquidation value without examining the prospects for the firm and the current value of the assets. The going-concern value is equal to the present value of the expected dividends arising from continued operation.

(Study Session 9, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 3

Question #4 of 34

Question ID: 1209553

When an analyst scrutinizes a firm's financial statements to try to discern how accurately the reported information reflects economic reality, and to evaluate the sustainability of the company's performance, the process is most likely to be referred to as a:

A) comprehensive basis of accounting analysis. ✗

B) quality of earnings analysis. ✓

C) reasonable assurance analysis. ✗

Explanation

The accuracy and level of detail disclosed in financial reports is referred to as the quality of earnings. When we say "quality of earnings analysis" we are generally referring to scrutinizing all a firm's financial statements (including the balance sheet) to try to determine not only the sustainability of the companies' performance but also how accurately the financial statements reflect economic reality.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #5 of 34

Question ID: 1209566

Important considerations for choosing an appropriate approach for valuing a given company are *least likely* to include:

A) Is the model suitable given the purpose of the analysis?

B) Is the model consistent with the investor's IPS?

C) Is the model appropriate based on the quality and availability of input data?

Explanation

Important considerations when choosing a valuation model include:

Does the model fit the characteristics of the company?

Is the model suitable given the purpose of the analysis?

Is the model appropriate based on the quality and availability of input data?

(Study Session 9, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 3

Question #6 of 34

Question ID: 1209555

Which of the following *least* accurately represents one of the primary steps of the equity valuation process described by Pinto, Henry, Robinson, and Stowe?

A) Decision making.

B) Assessing corporate governance.

C) Selecting a valuation model.

Explanation

The valuation process described by Pinto, Henry, Robinson, and Stowe consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete a valuation.
5. Decision making.

Corporate governance is important, but is not one of the primary steps.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #7 of 34

Question ID: 1209567

An ownership perspective can be important for an analyst determining the value of a share position. A controlling interest suggests the *most* appropriate model is a:

A) cash flow model. ✓

B) time series model. ✗

C) dividend discount model. ✗

Explanation

A controlling interest suggests a cash flow model may be most appropriate since the controlling interest would allow the purchaser to set dividend policy.

(Study Session 9, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 3

Question #8 of 34

Question ID: 1209551

Which of the following would cause an analyst to have concern about a firm's quality of earnings?

A) A firm books sales when orders are shipped. ✗

B) The firm took a write off for a recently impaired asset. ✗

C) The gain on the sale of a plant was included in operating earnings. ✓

Explanation

The inclusion of gains from the sale of assets as operating income would cause the analyst to question the quality of the firm's earnings.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #9 of 34

Question ID: 1209561

Which of the following two ratios are likely to be used for determining value as a function of company peer benchmarks?

A) Return on equity and net profit margin.

B) Price-to-sales and debt/equity.

C) Price-to-earnings and price-to-book.

Explanation

Relative valuation looks at market-based ratios of comparable companies in the industry. Price-to-sales, price-to-book, price-to-earnings, and price-to-cash flow are examples of ratios used in relative valuation analysis.

(Study Session 9, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 3

Joe Dentice has an opportunity to buy 5% of Gold Star Oil, Inc., a closely held oil company. He wants to value the company so as to make a decision on a fair price to pay for the investment.

Question #10 - 12 of 34

Question ID: 1209558

Consider the steps in the top down valuation approach as it is applicable for Gold Star. Dentice should forecast the growth of:

A) Gold Star, the growth of the oil industry, and then the growth of the overall economy.

B) each firm in the oil industry, the growth rate of the oil industry, and the growth rate of the economy.

C) the overall economy, growth of the industry, and the growth rate of Gold Star.

Explanation

The top down model for valuation would begin with analysis of the overall economy and the expectation of the growth rate in the economy. Further, the impact of the expected growth rate of the economy on the oil industry needs to be ascertained. The second component is the analysis of the oil industry in which Gold Star operates. That involves the determination of the competitive forces in the industry and the future threats and opportunities faced by the industry. It also determines the variables that determine the future profitability of the entire oil industry. The analyst then forms future expectations of these variables given the expectations about the overall economy. The expectations of variables determining the growth and profitability of the oil industry are then used to determine the expectations of the overall growth of Gold Star. In the company analysis, the analyst reviews the quality of earnings, financial ratios, management and intangibles to ascertain the growth prospects for the company. The analyst then selects an appropriate model to value the company. Assumptions used in the valuation must be clearly spelled out and updated to reflect new information.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #11 - 12 of 34

Question ID: 1209559

Which of the following models would be *most* suitable to value Gold Star?

A) Liquidation value.

B) Absolute valuation.

C) Relative valuation.

Explanation

Absolute valuation models or intrinsic value models such as the dividend growth rate model and the free cash flow model value a company independent of peer valuation. The valuation is based on the present value of cash-flows for the specific company. Relative valuation models such as P/E ratio compare the earnings multiple to that of similar companies to make a judgment about the valuation. If the P/E ratio is higher than peer company P/E ratio, it is said to be overvalued. Conversely, if the P/E ratio is lower than peer company P/E ratio, it is said to be undervalued. Caution should be taken to make sure that peer companies are indeed comparable. For the valuation of Gold Star, absolute valuation would be suitable since it is closely held and hence market valuation is not available.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #12 - 12 of 34

Question ID: 1209560

Which discounts must be taken into account while valuing the investment opportunity? Joe should take into account the:

A) marketability, liquidity, and majority discounts in the valuation.

B) marketability, liquidity, and minority discounts in the valuation.

C) marketability, liquidity, and control premium in the valuation.

Explanation

Since Gold Star is closely held, the investment is not easily marketable. Closely linked is the fact that the investment cannot be easily liquidated and the cost of selling the investment needs to be discounted from the value. Finally, since only 5% of the stock is being invested in, the control of the operations of the company still remains with the majority shareholders. This lack of control needs to be quantified and discounted from Gold Star's valuation.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #13 of 34

Question ID: 1209538

A valuation of a firm based on the current market price of its assets - liabilities is referred to as the firm's:

A) going-concern value.

B) operating value.

C) liquidation value.

Explanation

The liquidation value is based on the assumption that the firm will cease to operate and all of its assets will be sold to repay liabilities.

(Study Session 9, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 3

Question #14 of 34

Question ID: 1209554

Financial Analyst Davey Jarvis, CFA, is evaluating Laura's Chocolates, Inc., which processes nut-based toffee for world-wide distribution. Which of the following steps is Jarvis *most likely* to take as part of the top-down valuation process?

A) Evaluate price performance on an ongoing basis.

B) Perform momentum-based technical analysis.

C) Learn / understand the business.

Explanation

The valuation process consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete the valuation.
5. Decision making.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #15 of 34

Question ID: 1209543

For an analyst valuing public equities, the relevant concept of value is *most likely* to be:

A) fair market value.

B) orderly liquidation value.

C) intrinsic value.

Explanation

For an analyst valuing public equities, the most relevant definition of value is generally intrinsic value. A value based on a going-concern assumption, rather than a liquidation assumption, is the appropriate choice for a company that will continue to produce and sell goods. Fair market value is the most relevant definition of value to use in an agreement between the owners of a private business regarding the price at which the owners can sell their ownership interest.

(Study Session 9, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 3

Question #16 of 34

Question ID: 1209550

Notes to financial statements contain:

A) discussion of the firm's accounting practices and basis of presentation.

B) a description of the firm’s financial condition and future prospects.

C) important information about the firm's accounting practices and basis of presentation.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements. An overview by management of the company's past, present, and future can be found in the Management discussion and analysis (MD&A) section of a financial statement.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #17 of 34

Question ID: 1209549

What are three factors that would make a firm's accounting earnings less of a gauge of future economic performance? Late filings, unusually:

A) low amounts of loans to company insiders, and short tenure of senior management.

B) high amounts of loans to company insiders, and short tenure of senior management.

C) high amounts of loans to company insiders, and long tenure of senior management.

Explanation

Quality of earnings looks at the relationship between accounting earnings and economic profit potential of the firm. An analyst is concerned about anything that would render accounting earnings less useful as a gauge of the firm's future expected economic earnings. Warning signals include late filings, unusually high amounts of loans to company insiders, and short tenure of senior management.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #18 of 34

Question ID: 1209568

One justification for using multiple models to estimate firm value is:

A) the ability to streamline and economize the development process through repeated use of the same generic baseline.

B) the ability to examine differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated

C) the ability to learn from each successive model and to make improvements.

Explanation

One thing to remember with respect to choice of a valuation model is that the analyst does not have to consider only one. Using multiple models and examining differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated values.

(Study Session 9, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 3

Question #19 of 34

Question ID: 1209547

An analyst performing an asset valuation to detect investor's expectations about the future value of the variables that affect a stock's price is *most likely* using the valuation for:

A) generating a fairness opinion.

B) projecting the value of corporate actions.

C) reading the market.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Reading the market entails detecting investor's expectations about the future value of the variables that affect a stock's price.

(Study Session 9, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 3

Question #20 of 34

Question ID: 1209544

Which of the following is NOT a use of asset valuation?

A) Projecting the value of corporate actions.

B) Issuing fairness opinions.

C) Estimating inflation rates.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Asset valuation is not used to project inflation rates.

(Study Session 9, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 3

Question #21 of 34

Question ID: 1209534

Valuation models for equities contain estimates of required returns and:

A) expected future cash flows.

B) an assumed continuation of past cash flows.

C) known future cash flows.

Explanation

Valuation models used for equities require the analyst to estimate the required return applicable to the investment and to develop an expectation of future cash flows. While cash flows for fixed-income investments are stated, no such definition is available for equities.

(Study Session 9, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 3

Question #22 of 34

Question ID: 1209556

Disclosures of accounting practices and basis are most likely to be made in which part of a firm's financial reports?

A) Footnotes.

B) Management's discussion and analysis (MD&A).

C) The audit report.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #23 of 34

Question ID: 1209537

How can we account for different valuations for the same firm from several analysts even if they use the same required returns?

A) Valuations are based on the analyst's expectations.

B) The analysts may be biased with personal opinions about management.

C) Valuation models contain random errors.

Explanation

Valuation is based on *expectations* of future cash flows rather than known values. Each analyst will build expectations of cash flows from the fundamental data and from other factors, internal and external, that the analyst believes will affect the firm's performance.

(Study Session 9, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 3

Question #24 of 34

Question ID: 1209536

A wise analyst will examine a valuation to determine:

A) ways to enhance a client's valuation.

B) its sensitivity to changes in expectations.

C) how well it will be received by the firm's management.

Explanation

The results of valuation models can be very sensitive to changes in the expectations incorporated in the model. Analysis of a valuation's sensitivity to the expectations and a review of the confidence the analyst has in the expectations may lead to the use of a valuation range rather than a pin-point value.

(Study Session 9, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 3

Question #25 of 34

Question ID: 1209562

A valuation of a firm based on a review of other firms' price to earnings, price to sales, and price to return on investment ratios is an example of a:

A) relative valuation.

B) broad-based valuation.

C) fundamental valuation.

Explanation

An approach using market multiples to establish the value of the subject firm in relation to similar firms is an example of a relative valuation approach.

(Study Session 9, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 3

Question #26 of 34

Question ID: 1209548

An analyst is *most likely* to review the footnotes to a firm's financial statements to find information about the firm's:

A) accounting practices.

B) operation.

C) cash flow activities.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements. The profit and loss statement provides information on the operation of the firm. The statement of cash flows is the best source of data on a company's cash flow activities such as operating, investing and financing.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #27 of 34

Question ID: 1209564

A valuation of a firm based on the intrinsic value of the firm's investment characteristics is known as an:

A) absolution valuation.

B) absolute valuation.

C) asset based valuation.

Explanation

An absolute valuation approach attempts to determine the value of the firm based on its specific characteristics without regard to the market prices of other firms.

(Study Session 9, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 3

Question #28 of 34

Question ID: 1209535

The goal of asset valuation, based on the expected future cash flows of an asset, is to establish an asset's:

A) market value.

B) relative value.

C) intrinsic value.

Explanation

Asset valuation based on the expected future cash flows is utilized to estimate an asset's intrinsic value, or the value derived from the asset's investment characteristics.

(Study Session 9, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 3

Question #29 of 34

Question ID: 1209545

Minority shareholders often do not have control of the price at which the firm will be sold or merged with another firm. In order to safeguard their interests, minority shareholders will often seek an analyst's opinion of the value of the firm. This opinion is referred to as a:

A) minority opinion. ✗

B) second opinion. ✗

C) fairness opinion. ✓

Explanation

Minority shareholders are often dependent upon an analyst's opinion about the fairness of a price to be received. Hence the term *fairness opinion*.

(Study Session 9, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 3

Question #30 of 34

Question ID: 1209546

Which of the following is *least likely* a use of equity valuation?

A) Assessing Corporate governance. ✓

B) Projecting the value of corporate actions. ✗

C) Issuing fairness opinions. ✗

Explanation

Equity valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Equity valuation is not specifically related to corporate governance.

(Study Session 9, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 3

Question #31 of 34

Question ID: 1209542

Liquidation value is the:

A) cash generated by terminating a business, selling its assets, and repaying liabilities.

B) market value of the total assets less the market value of the total liabilities.

C) present value of future cash flow less the possible liquidation cost.

Explanation

Liquidation value is the cash generated by terminating a business, selling all of its assets, and repaying liabilities.

(Study Session 9, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 3

Question #32 of 34

Question ID: 1209565

The value of a conglomerate derived using a sum-of-the-parts valuation would *least accurately* be called the:

A) liquidation value.

B) breakup value.

C) private market value.

Explanation

Sum-of-the-parts valuation totals the estimated values of each of the company's business divisions as independent going concerns. The value derived using a sum-of-the-parts valuation is also sometimes called the private market value or the breakup value, even when such a restructuring is not necessarily expected.

(Study Session 9, Module 24.1, LOS 24.g)

Related Material

SchweserNotes - Book 3

Question #33 of 34

Question ID: 1209552

Overestimating the growth rate of a firm in using a valuation model would result in a value that is likely to be:

A) can't tell from this information.

B) too high.

C) too low.

Explanation

Using an estimate for a firm's growth rate that is too high would overstate the amount of future returns, resulting in a present value that is too high.

(Study Session 9, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 3

Question #34 of 34

Question ID: 1209540

A valuation of a firm based on the assumption that the firm will continue to operate is referred to as its:

A) going-concern value.

B) status quo value.

C) operating value.

Explanation

The going-concern value is based on the assumption that the firm will continue to operate and the firm's value is the present value of its future dividends.

(Study Session 9, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 3