LO.a: Define valuation and intrinsic value and explain sources of perceived mispricing.

1. Which of the following statements is *most likely* correct?
   A. An investment is expected to yield abnormal positive returns when its market price is higher than its intrinsic value.
   B. When market prices accurately reflect all information, investors would be motivated to incur the costs of information gathering.
   C. Active management seeks to earn excess risk adjusted returns by way of investment analysis.

2. "The value of an asset given a theoretically complete understanding of its investment characteristics" is known as the:
   A. intrinsic value.
   B. liquidation value.
   C. market value.

3. Active managers try to identify mispricing which is the difference between:
   A. estimated intrinsic value and intrinsic value.
   B. unobservable intrinsic value and market price.
   C. estimated intrinsic value and market price.

LO.b: Explain the going concern assumption and contrast a going concern value to a liquidation value.

4. Which of the following statements is *most likely* accurate?
   A. The going concern assumption implies that a business will continue its activities for at least ten years.
   B. The liquidation value of a company is the value of the company assigned by its liquidators during bankruptcy.
   C. Generally, the value of a company if it continues operation is different from its value if it were to be dissolved immediately.

LO.c: Describe definitions of value and justify which definition of value is most relevant to public company valuation.

5. "Fair market value" is most accurately described by which of the following statements?
   A. The value at which the asset is traded in the market.
   B. The price at which an asset changes hands between a willing buyer and a willing seller when neither party is under compulsion to trade.
   C. Value of an investment to a particular buyer based on his/her needs and expectations.

LO.d: Describe applications of equity valuation

6. Which of the following statements is *least likely* correct?
   A. Equity valuation is used by analysts to extract market expectations reflected in stock prices.

B. An investment bank can utilize equity valuation to offer a fairness opinion on a merger.
C. Equity valuation is not relevant when determining share-based compensation.

LO.e: Describe questions that should be addressed in conducting an industry and competitive analysis.

7. Which of the following is an indication of poor earnings quality?
   A. The company does not use off-balance sheet financing.
   B. The company reports operating and non-operating income separately.
   C. The company recognizes revenue when orders are received but holds back goods for future delivery.

8. Which of the following indicators *least likely* represent poor financial reporting quality?
   A. Not assuming long depreciable lives for assets.
   B. Using special purpose entities to remove assets from the balance sheet.
   C. Capitalizing expenses to delay their recognition.

9. Which of the following questions are not relevant to understanding a company's business model?
   A. How profitable are the industries in which the company operates?
   B. What is an appropriate discount rate to use in valuation of the company?
   C. What is the company's competitive strategy?

LO.f: Contrast absolute and relative valuation models and describe examples of each type of model.

10. Which of the following is a relative valuation method?
    A. Discounted cash flow valuation
    B. Asset based valuation
    C. Price to sales valuation

LO.g: Describe sum-of-the-parts valuation and conglomerate discounts.

11. In which of the following scenarios is sum-of-parts valuation *most* useful?
    A. When a company owns different subsidiaries in the same business segment.
    B. When the company is going into liquidation and dissolving its individual business segments.
    C. When the company operates in different business segments each with its unique characteristics.

12. Which of the following is the *least* appropriate rationale for conglomerate discounts?
    A. The company's allocation of capital to different business divisions may not maximize shareholders' wealth.
    B. The company may have diversified in order to hide poor operating performance.
    C. The liquidation value of business segments is less than their going concern value.

LO.h: Explain broad criteria for choosing an appropriate approach for valuing a given company.

13. When performing equity valuation, an analyst should take into account which of the following criteria for selection of a valuation model?
    A. The characteristics of the business being valued.
    B. The purpose for which the valuation is performed.
    C. Both A and B.

Solutions

1. **C** is correct**.** The purpose of active management is to seek excess risk adjusted returns by way of investment analysis. An investment is NOT expected to yield abnormal positive returns when its market price is higher than its intrinsic value. When market prices accurately reflect all information, investors would NOT be motivated to incur the costs of information gathering. Section 2.1.

2. **A** is correct. Intrinsic value of an asset is the value given a hypothetically complete understanding of its investment characteristics. Section 2.1.

3. **B** is correct. True mispricing is the difference between the asset's true but unobservable intrinsic value and its market price that contributes to excess risk-adjusted return (alpha) sought by active managers. Section 2.1.

4. **C** is correct. Generally, the going concern value of a company is different from its liquidation value. This is due to the collective value of assets and human capital managing those assets. The going concern assumption implies that the business is expected to continue operation for the foreseeable future; there is no time limit. The liquidation value of a business is if it were to be dissolved and its assets sold individually. Section 2.1.2.

5. **B** is correct. The fair market value is the price at which an asset changes hands between a willing buyer and a willing seller when neither party is under compulsion to trade. Section 2.1.3.

6. **C** is correct. Equity valuation is used to value share-based compensation of employees. Section 2.2.

7. **C** is correct. Companies may recognize revenue early and hold back stock for delivery to boost revenues and expenses, thus a sign of a possible problem with a company's earnings quality. Use of off-balance sheet financing such as leasing does not appear on the balance sheet, and may affect earnings. Separation of operating gains from non-operating gains is an indication of good quality earnings. Section 3.1.4.

8. **A** is correct. Using aggressive estimates and assumptions such as long depreciable lives, may indicate an attempt to either boost current income or hide problems with performance in the current period. Using SPEs to remove risky assets from the balance sheet and capitalizing expenses that otherwise have to be expensed are signs of poor financial reporting. Section 3.1.4.

9. **B** is correct. Analysis related to discount rate and cash flows are part of equity valuation models. The valuation models are chosen once the industry and competitive analysis have been completed and company performance has been forecasted. Section 3.

10. **C** is correct. Price to sales multiple valuation is a relative valuation method. Discounted cash flow and asset based valuation are absolute valuation methods. Section 3.3.

11. **C** is correct. Sum of parts is most useful when the company operates in different business segments each with its unique characteristics. Section 3.3.3.

12. **C** is correct. The most common explanations for conglomerate discounts are that the company's allocation of capital to different business divisions is inefficient since the overall value does not increase, and that the company may have diversified in order to hide poor operating performance. The liquidation value being less than going concern value is NOT a reason for the application of conglomerate discounts. Section 3.3.3.

13. **C** is correct. The analyst should take into account both the characteristics of the business and purpose of valuation when selecting a valuation model. Section 3.3.4.

